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A REPORT CARD ON THE U.S. ECONOMY

HEARINGS

BEFORE THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES
NINETY-NINTH CONGRESS
FIRST SESSION

OCTOBER 2 AND 17, 1985

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A REPORT CARD ON THE U.S. ECONOMY

WEDNESDAY, OCTOBER 2, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ECONOMIC STABILIZATION,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to call, at 11:05 a.m., in room 2220, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Chairman LaFalce; Representatives Kaptur, Carper, and McCandless.

Chairman **LaFalce**. The Subcommittee on Economic Stabilization will come to order.

In 1983 and early 1984, the U.S. economy grew at a very robust 7-percent rate. However, for the last five quarters, our economy has been sluggish, posing an average growth of only 2 percent. This prompted CBO Director Rudy Penner to recently describe the economic recovery since 1982 as "remarkably average."

Today the subcommittee wishes to examine the recovery we have experienced since 1982. How does it compare to previous recoveries? Where can we expect to go from here?

Economics, as we all know, is a perplexing field of study. One economist's "iron law" relationship is mere coincidence to others. This recovery has defied the "iron laws" of many economists. Key economic indicators have been moving in very unusual patterns. Each of these new patterns raises some troubling questions about the stability of our economy.

For example, Federal budget deficits have ordinarily expanded in recessions but contracted during recovery periods. Now we find that—even though the economy has been growing for a third straight year—the Federal budget deficit has been widening, rather than contracting. What does that mean for future deficits and for our fiscal stabilizers, if and when the next recession occurs?

Traditionally, the total of private and public debt has grown at roughly the same rate as the GNP. In recent years, total debt—not only public, but private—has raced far ahead of GNP growth. On the other side of the coin, savings rates are at all-time lows despite new tax and interest rate incentives to save. How much of this rapidly expanding debt is unsound? Can households or businesses be expected to slow their borrowing any time soon and cut back spending?

Monetarists and non-monetarists alike have observed that, until this year, nominal GNP was growing several percentage points faster than M1—the narrowly defined measure of the money stock.

This year, however, M1 has accelerated at a rate in the double digits while nominal GNP has decelerated to barely 5-percent growth. Does this leave the Fed without a gauge to make consistent policy? On the other hand, should we be concerned that a new bout of inflation is coming?

Yet another anomaly has been the strength of the dollar in the face of extraordinary trade and current account deficits. Largely as a result, from mid-1984 to mid-1985, United States demand for goods grew more than 3 percent, while U.S. goods production expanded only one-half of 1 percent. If the dollar's strength finally subsides, can we expect an upward thrust from expanding exports or shrinking imports that put downward pressure on foreign economies?

Perhaps related to such anomalies, there seems to be an unusually wide dispersion among economic forecasts for the United States in the near term. We are pleased to have a panel of distinguished forecasters who take positions across the spectrum. It is my understanding that Mr. Evans predicts relatively strong growth for the coming year. Mr. Sinai thinks we will have slow growth. Mr. Levy worries that we may have no growth. We expect a lively discussion.

Why don't we go from fast to slow and perhaps no growth. Mr. Evans, why don't we start with you.

STATEMENT OF MICHAEL K. EVANS, EVANS ECONOMICS

Mr. EVANS. Thank you very much, Mr. Chairman.

I am very pleased to be here this morning. You are indeed correct in your statement that I expect rapid growth for 1986, which I think will average about 4.5 percent. I think there are several factors which would cause this rapid growth, one of them is that I see a strong recovery in consumer spending which I believe is already started in the August and September statistics, and which I expect will continue for several more quarters.

I am aware that the debt-income ratio of incomers is quite high relative to historical standards. Yet, I think that the average consumer is not particularly concerned about this so long as the Fed continues to expand credit and as long as interest rates stay near current levels.

While interest rates are indeed very high by historical levels, the average consumer views them as being much lower than they were 3 or 4 years ago, and hence in that sense quite reasonable.

Now, we have certainly seen the effect of a 7.7-percent interest rate on auto financing which is increasing car sales by as much as 50 percent, and even though part of that is just a short-term timing phenomenon, that indicates the degree to which consumers are receptive to monetary ease which we certainly have this year.

I think capital spending will be strong. Capital spending responds to interest rates with a greater lag, but from last September to the present, interest rates have dropped about 3.5-percentage points, and I believe that this will continue to raise capital spending and that should grow to close to 10 percent over the next year.

The housing industry is coming back strongly, housing starts are 1.8 million. Home sales of new and existing homes have increased strongly in the last 3 or 4 months. As a result, the decline in mortgage interest rates. The housing sector looks strong.

And the remaining sector, the one that put the biggest drag on the economy, is net exports. Here we think the decline in the value of the dollar will stimulate net exports. We have seen numbers in July and August that the trade balance, even though it is horrendously large by historical standards, has dropped considerably from a peak of $13.4 billion in July to an average of $10 billion, $13.4 billion in June to an average of $10 billion in July and August. We think that the trade deficit will continue to remain at lower levels than it was in the first half of this year.

So for the next few months consumption, investment, housing and net exports all appear to be poised in the positive direction.

The real question is how long can this last? Already the economy has shown signs of doing the impossible. We have always been taught that if we have an excess of growth in the money supply and credit aggregates that would be inflationary and if we have a large budget deficit, that that will be inflationary, and if you combine the two obviously you would have higher inflation. Yet we have had exactly those circumstances over the last 3 years. The money supply has grown at double digit rates. The deficit remains close to 5 percent of GNP and yet, inflation continues to go down.

Spot commodity prices have fallen 30 percent between their levels in April 1984 and their current levels, for example.

The way this was accomplished, however, may be coming to an end, and the reason I say that is because this sleight of hand as it were, was accomplished primarily by a stronger dollar. When we didn't have domestic funds necessary to finance the credit needs of the Government and private sector, we were able to import net capital which in recent quarters, has been running at an annual rate of $120 billion. The inflation was kept down.

Now, however, that was about to change, I believe. I think that the announcement which was made approximately a week-and-a-half ago by the Federal Reserve bank in conjunction with the so-called G–5 nations that the dollar should move lower will in fact have the desired effect. We saw a tremendous drop of 5 percent in the value of the dollar overnight, which has never happened before, and since then the dollar has continued to drift lower, although obviously at a slower pace.

I believe that the Fed and the G–5 nations would like to see the dollar decline at least another 5 to 10 percent in the next year, and possibly more so that the pressure will be downward on the dollar. By the time this is through, the dollar will have declined 30 percent from its peak values, which occurred in March 1985.

Now, that raises a very important question, what happens to our pattern of strong growth, stable interest rates, and lower inflation, if the dollar in fact declines that much?

Now, we have some historical precedents and they are not favorable. We had de facto devaluations of the dollar in 1971–72 under Mr. Nixon, and in 1977–78 under Mr. Carter. In both cases, the dollar declined approximately 25 percent from its previous values. In both those cases, we had substantially higher interest rates, substantially higher inflation, and the economy eventually ended up in a recession.

Now, things are not equal and they are not the same as they were then. We had an energy crisis in both of those cases which we are obviously not having now. We had food shortages which we don't have now. But even abstracting from those changes the decline of the dollar did produce higher interest rates and higher inflation.

So the question is whether that will continue this time.

Now, here my conclusions are somewhat eclectic in the sense that I think we will have increase in interest and inflation rates, but not as much as earlier. I have concluded and predicted that the inflation rate, which is now about 3 percent, will probably increase to 4 to 5 percent next year, and that interest rates will probably rise about 1.5 percentage points from their current levels by mid-1986.

One of the factors that is different, far different from the era of the 1970s has been the behavior of wage rates. The real wage rate has decreased in 1984 and it apparently will decrease in 1985. We have never had a period of general prosperity and modern inflation where real wages went down. They have always gone up.

It seems to me there has been an institutional shift in wage rates, the way they are determined, declining power of the unions, import pressures from overseas and other factors, which means that wage rates probably will only rise 3 to 4 percent over the next 2 years. That will restrain inflation.

I don't think the commodity prices will skyrocket.

Chairman **LaFalce**. You mean nominal wage rates.

Mr. **Evans**. Three to four, yes, that is right, no real increase in wages.

Commodity prices, I don't think, will skyrocket, either. We have an energy clog and energy prices are higher in the short-term because of seasonal factors and bombing of Kharg Island. I think energy prices will probably stabilize for the next year as will food prices.

Commodities should move up slightly but again, nothing to get excited about. So inflation, even though it moves up to 4- to 5-percent rate, will remain well under control.

Now, the outlook for interest rates, I would submit, is not as sanquine because we have had this $120 billion flow of capital into this country which has been increasing at a rate of about $40 billion a year on balance for the last 3 years.

I don't think this is going to go away but I would submit that with the lower dollar this flow might diminish somewhat so that instead of adding $40 billion a year we might see a subtraction of $10 billion or $20 billion, a net swing of $50 billion to $60 billion a year.

When that happens, we will have to find other sources for those funds or interest rates will have to rise. I don't see any other way out of this particular box.

So now, then, the question is where do the funds come from? One answer, of course, is that the Government deficit be reduced through some combination of spending cuts or tax increases.

My personal opinion is that the outlook for that is not very likely over the next 2 years. If that does not happen, then we would either have to have substantial increase in private sector savings or a considerable rise in interest rates. I would predict the latter would happen, and so that interest rates will rise 1 to 1.5 percentage points by mid-1986.

If the Fed maintains an easy monetary policy throughout this period, the boom would continue although at somewhat lower rates after 1986.

If the Fed, on the other hand, decides that the dollar has gone down far enough and decides to tighten, that will throw the economy into a recession in 1987.

My standard forecast is for about a 2-percent growth the year after next, because of the problem of the lack of foreign investment, somewhat higher interest rates and a slowdown.

Nonetheless——

Chairman **LaFalce**. Two percent in 1987.

Mr. **Evans**. Yes, 4.5 percent for 1986, but 2 percent for 1987.

I gather from my comments that that puts me in the optimistic quadrant of economists, but the key to the forecast is what happens to the dollar which I think will go down; what happens to inflation and how the Fed reacts.

If the Government deficit were to be cut substantially by an amount to offset the reduced foreign capital, then I think the boom will continue indefinitely. However, since that is not my forecast, I think we will have some negative effects of a lower dollar and some slowdown, although not a recession in 1987.

[The prepared statement of Mr. Evans follows:]

SUMMARY OF TESTIMONY TO HOUSE BANKING COMMITTEE

by Michael K. Evans

October 2, 1985

1. Both real growth and inflation seem to be well under control, so the Fed has turned its attention to the value of the dollar. The G-5 decision will definitely result in a lower value of the dollar over the next two to three years; it is not merely a holding or diversionary action.

2. In the past, devaluation of the dollar has always resulted in higher inflation because the price of both imports and import substitutes have increased. Furthermore, productivity has declined and wage rates have risen faster because the pressure of foreign competition has diminished.

3. Also in the past, a devaluation of the dollar has always resulted in higher interest rates. To replace the funds lost from foreign investors, interest rates must rise to attract more funds from domestic sources. This is in addition to the rise stemming in interest stemming from higher inflation.

4. The increase in inflation and interest rates has always caused the monetary authorities to tighten, resulting in recessions approximately two years after the value of the dollar started to decline.

Thus the effect of the lower dollar could result in the following economic scenarios:

A. Repeat of 1972-74 and 1978-80. While inflation would not rise to double-digit levels again, it would increase to 6% next year and the economy would be thrown into recession in 1987.

B. Inflation and interest rates rise only minimally because the Federal government cuts the deficit, thereby offsetting both the stimulus from higher net exports and providing the additional funds to replace those provided by foreign investors.

C. The problems of the past are no longer with us, since inflation is dead and the decline in the dollar will not set in motion the same forces that occurred in the 1970's. Thus the recovery will continue indefinitely.

Although at face value, scenario (C) might seem the least likely, it is currently the consensus view. Virtually no economist expects a significant rise in inflation either this year or at any time during 1986. The principal arguments mustered against inflation are the following:

1. The dollar declined 20% between early March and mid-August, and yet industrial spot market prices continued to decline nonetheless.

2. The world oversupply of virtually all basic commodities, including but certainly not limited to food and energy, will keep commodity prices steady even if the dollar does decline.

3. Inflationary expectations are dead, so the speculative stockpiling that ordinarily pushes commodity prices up when the dollar declines will not occur this time.

4. Institutional changes in wage rates, tied to a decline in the power of unions brought about by the Reagan Administration, will keep labor costs from accelerating even with a weaker dollar. In the same vein, productivity gains will continue.

5. The dollar is still high enough, even after some further devaluation, that U.S. goods remain uncompetitive with many foreign producers; hence pressure from imports will still remain strong, and domestic firms will not be able to raise their prices.

6. Importers will swallow their cost increases due to the weaker dollar in order to maintain market share, so that the usual increase in import prices will not occur.

The outlook for inflation and interest rates, and thus for real growth in 1986 and 1987, hinges on assessing the validity of assumptions (1) - (6) listed directly above.

The evidence on these points is quite mixed, and certainly does not point all in the same directon. However, after assessing these effects, we reach the conclusion that inflation probably will rise to the 4-5% range by late 1986, that interest rates will increase at least 1% and maybe 1 1/2% over the next year, and that the economy will enter another slowdown, although not an outright recession, in late 1986 or early 1987. Capsule analyses of each of these six points are as follows:

1. The main reason that commodity prices declined even though the dollar weakened earlier this year was that the U.S. economy was quite weak. However, we think real growth is turning around and will average 4 1/2% for at least the next three quarters. Since higher growth is an essential ingredient to our forecast of somewhat higher inflation, the factors causing this improvement in the economy are discussed in a separate section of this testimony.

2. While world commodity prices will not increase much over the next year, we think they have troughed. Food prices will not fall much further, and oil prices have shown surprising strength in the past few months. Part of this is due to temporary factors, such as unusually low inventories and the bombing of Kharg Island by the Iraqis, but we do not share the viewpoint that oil prices will head sharply lower next year. Instead, stronger growth on a worldwide basis will strengthen the demand for energy in general and oil in particular, and keep prices from falling further.

3. Inflationary expectations did diminish earlier this year, but that was based largely on the assumption that the Fed would continue to fight inflation and that the dollar would remain strong. Once skepticism vanishes about the

determination of the Fed and other G-5 countries to push the dollar down and keep it lower, inflationary expectations are likely to rise again.

4. Wage rates have undergone a significant change, and we think they will continue to trail inflation for the next several years. Similarly, productivity gains are still rising strongly in the manufacturing sector, so that unit labor costs probably will increase only 2% to 3% next year, hence keep inflation from rising as much as it has in the past when the dollar was devalued.

5. A decline in the dollar to the DM 2.40-2.50 level and the yen 200-210 level would make substantial proportions of the manufacturing sector competitive in world markets once again. Consequently, we think that most domestic firms probably will try to raise prices in 1986, particularly if demand remains strong.

6. While importers will initially be willing to swallow the effects of a lower dollar, after these effects cumulate for a year or so, it is likely that they will follow domestic prices higher. We estimate that approximately 40% of this change in price due to fluctuations in the dollar — in either direction — is ultimately passed along to the consumer.

The issue of the demand and supply of loanable funds is a more serious one. The decline in net exports over the past three years has resulted in approximately a $40 billion annual increase in foreign investment in this country; with the devaluation of the dollar, this flow will stabilize instead of increasing $40 billion per year, and may even drop somewhat. Hence $40 billion per year will have to be found from other sources if interest rates are to remain stable. Since we do not see any reason to expect changes in consumer or corporate saving patterns, the change must necessarily occur in the government sector. Since recent Congressional actions make this seem quite unlikely, it follows that interest rates will rise 1% to 1 1/2% as the result of the devaluation of the dollar. This in turn will cause much slower growth by the end of next year.

4 1/2% GROWTH RATE AHEAD FOR NEXT THREE QUARTERS

The Flash Report provided a misleading picture of where the economy is actually heading. That number should be revised up to 3.5% next month and 4% by the time the second revisions are released in December. Two factors are likely to account for this upward revision. First, consumer spending will be quite strong in September, and not just in autos. Second, the Commerce Department has underestimated the improvement in foreign trade this quarter, as has already become clear from the August numbers.

However, the key issue in predicting where the economy is heading is clearly the consumer, so naturally that is where most discussion is focused. The arguments against consumer spending continuing to rise at above-average rates are (a) income is growing slowly; and (b) credit has been rising too rapidly, pushing the debt/income ratio is too high, or alternatively consumers are spending so much money paying back old debts they do not have sufficient funds for more new purchases.

The income argument is a pretty thin one. The fact that farm income has declined sharply over the past four months does not mean that a sudden malaise that has smitten the farm belt, but merely reflects the way in which government subsidy payments are entered into the national income accounts. Of course the farm sector is in trouble, but no more so than it was six or twelve months ago. Indeed, farm income should not really be counted as part of personal income at all; it is more akin to profits. The other factor that makes no sense is the decline in imputed personal interest income, which consumers never see in any case. The key income variable to watch in the short term is wages and salaries. Even these have not been growing very rapidly, increasing at only a 5% annual rate over the past four months, at the same time the rate of inflation has declined to 3%, so in real terms the gain is still a respectable 2% — compared to the 1.3% growth rate in total personal income.

Furthermore, employment gains are likely to increase more rapidly in the near future. Everyone has been so busy chronicling the decline of the manufacturing sector that few have noticed the turnaround that has finally begun. The anemic productivity gains that marked the first phase of the cycle have given way to more impressive increases — particularly for production workers. We thus look for employment gains in the manufacturing sector to increase about 50,000 per month for the rest of the year; these gains will spur additional hiring in the tertiary sectors of the economy.

As far as the willingness of consumers to spend, that should have been pretty well answered by the rousing success of the response to the cut-rate financing offered by Detroit. It is true enough that some consumers are buying now instead of later — or earlier — because the price is right, but this kind of subsidy does not always work and in fact acheived very mediocre results when tried during the recession days of 1981 and 1982. If consumers were really stretched to the limit, they would be much less willing to sign up for an additional set of payments over the next four or five years even with such low financing costs.

The most commonly heard argument relative to car sales is that they are being borrowed from future months and hence do not represent an improvement in the economy at all. In order to address this issue, we need to estimate (a) the underlying rate of demand for new car sales, (b) the permanent, as opposed to temporary, increase caused by the 7.7% financing, and (c) the degree to which the slump in sales in July and early August reflected consumers waiting for a better deal at the end of the summer, when Detroit usually offers incentives to unload excess cars.

Before the GM strikes last fall, car sales were fairly steady at an annual rate of 10.5 million; they declined during and shortly after the strike, and then increased to over 11 million with catch-up buying. By June, though, sales settled back to normal, and then slumped in July and even more in early August, triggering this financing bonanza. As a result, car sales, which had fallen to a 10.2 million rate in July and then rebounded to 12.6 million in August, will taper off slightly to 12 million in September, resulting in a quarterly rate of 11.6 million, or about 1.1 million above what we have designated as the equilibrium level. All figures are at annual rates, of course, so this amounts to an actual increase of 275,000 additional cars sold in August and September.

The lower financing charges reduce the overall cost of a car bought on time by approximately 12%; between 60% and 70% of new cars are purchased on time, so the overall reduction in price is between 8% and 9%. We have previously found a long-term price elasticity of about 0.7%, which suggests that permanent car sales were raised at least 5% over this period. In other words, of the additional 275,000 cars sold, about half that increase represented consumers who would not have bought a new car this year but took advantage of the low financing rates — as opposed to those who simply moved up their purchase date by a few months. That leaves less than 0.15 million cars where sales were borrowed from the future, or 0.3 million at annual rates if the alleged shortfall were spread over the next two quarters.

That could justify a decline in new car sales to 10.2 million for the next two quarters. However, with the economy starting to pick up again, interest rates generally stable or declining, and the drop in unemployment, we think the equilibrium rate has risen slightly from the 10.5 million of 1984. If we take the general rule which has worked well in the past, namely that a 1% decline in the unemployment rate results in a 0.5 million increase in car sales, then the reduction in unemployment from 7.5% last fall to 7% or slightly less this fall should raise sales about 0.3 million, leaving the total at 10.5 million. This is indeed our forecast.

Another factor to consider is that Detroit, cheered by the greater than expected response to this cut-rate financing, has decided to step up its production schedules for the fourth quarter more than usual, so that gross auto product will rise and give GNP an additional boost. If these cars do not sell, one could argue that would mean cutbacks early in 1986. However, it is our guess that if car sales slump much below the 10.5 million rate, the reductions in financing costs will reappear, and sales will stay near that level in any case.

Autos are not the only component of consumption, of course. Non-auto sales have been very sluggish over the past four months, with purchases of other durables and nondurables showing no gain at all even in current dollars. However, as explained previously, this is largely due to a summer slump caused by an unusually large percentage of consumers vacationing overseas. Obviously we do not have complete September statistics at this point, but back-to-school sales were reported as very encouraging and anecdotal evidence suggests that strong sales continued throughout the month. We will need the October retail and consumption numbers to verify this point, but at the moment the most recent evidence clearly suggests an end to the summer malaise in consumption.

Since excessive debt, like beauty, is in the eyes of the beholder, it is not possible to offer a definitive statement about when consumers exceed that fine line and start cutting back on current consumption to pay past bills. However, in our view consumers are nowhere near that mark and will not be for several quarters so long as interest rates do not rise very much. The composition of consumer instalment credit has changed somewhat with the explosion of borrowing with bank credit cards; most of that is repaid in a month and actually represents short-term transactions that are not really credit at all but save the bother of carrying large amounts of cash. In addition, with auto loans stretched from three to four and now in many cases five years, the higher level of debt is somewhat misleading in that payments in real terms have not increased but are merely in place for a longer period of time. That does mean less flexibility if a recession were to develop from other sources, but not necessarily a higher proportion of income spent on repayments.

The fact that interest rates have declined 3 1/2% over the past year will have a very favorable effect on those with adjustable rate mortgages. We have not mentioned this very much in the past few months as the subject has died down a bit, but many homeowners obtained mortgages with first year rates at 9% to 10% with the realization that these rates could rise to 13% or 14% over the next two years. However, since most of these rates are tied to some market interest rates — Treasury bills or bonds being the most common — the sharp decline in rates means that the upward adjustment in the variable rate for many ARM holders will be small or nonexistant. Most homebuyers went into these arrangements with their eyes open, knowing they would probably have to pay higher rates in future years. They planned to meet these higher payments either with higher expected income in future years, or by treating the difference between market and first year mortgage rates as one-time expenses: moving costs, furnishing the home, or repairs upon moving in. If these additional funds then continue to be available in the second and third years, consumer spending should continue strong either in these categories or as funds are switched to buy other goods and services. In either case, the lack of any sizable increase in mortgage payments will be viewed in many cases as an unexpected bonus.

In other words, the current peak in the debt/income ratio provides very little information about the future plans for consumer spending because the composition of debt has changed, because the income statistics themselves are very misleading, and because the decline in rates means holders of ARMs will not have to cut back their spending in the coming year, as had earlier been feared. When coupled with strong gains in employment, consumption excluding autos will lead the economy to a 4 1/2% growth rate over at least the next three quarters. The other factor that will help accomplish this is the low rate of inflation, which is discussed next.

REAL WAGES WILL CONTINUE TO DECLINE

Real wages — more precisely, average hourly earnings adjusted for overtime and interindustry mix deflated by the CPI-W — generally decline during periods of very rapid inflation or recessions, but they had never fallen during a period of positive growth and stable inflation until 1984. It appears that 1985 will be a repeat performance, because during the first eight months of the year, wage rates have increased at only a 2% rate while the CPI has risen at slightly more than a 3% rate. This startling decline in the real wage during a period of general economic prosperity is one of the major factors causing inflation to remain stable, and merits further discussion.

The old theory about real wage rates being inversely correlated with the unemployment rate — the old Phillips curve — never really worked very well in this country and did not exist at all in most other industrialized countries. If it had existed, we would expect the real wage to fall or at least rise less rapidly during years of recession; yet the rate of increase slowed only 3 times in the 8 postwar recessions (excluding the reconversion immediately following World War II). Some have suggested that wage rates lag behind inflation and unemployment; yet if a lag of one year is considered, it turns out that the gain in real wages slowed only once in eight times in the years immediately following a recession. Thus the links between real wages and unemployment are essentially nonexistant, and we cannot point to high unemployment as the principal factor for the decline in real wages in the past two years — particularly since the economy has been fairly robust over this period and the current unemployment rate of 7%, while still too high to be satisfactory, is only 1/2% above the average during the decade of the 1970's.

Instead, we would argue that the major causes for the decline in the real wage rate are more institutional than economic. Of these causes, the first is the ascendancy of the Reagan Administration itself, with its more conservative bias; this received an impressive boost because of Mr. Reagan's handling of the PATCO crisis, resulting in the firing of the striking air controllers. The second is the push toward deregulation, which has unquestionably reduced wages in the airline and trucking industries; these bellwether settlements have had an important impact on many non-manufacturing industries. The third is the threat of foreign competition and the wholesale movement of manufacturing facilities overseas, which has cut deeply into the ranks of manufacturing employment. Before, workers generally assumed that if they were laid off during recessions, their jobs would reappear as soon as the economy recovered; now no such assumption is warranted. In this sense the dollar is a determinant of wages directly as well as prices. The fourth is the general demise of the unions. To a certain extent this can be traced to the erosion of manufacturing jobs and the push provided by the Reagan Administration, but even if these had not taken place, the switch to a more service-oriented economy would have decimated union strength. The fifth factor is the substantial tax cut, which means that workers received bigger take-home paychecks even if their pretax real wages did not rise. Even though there are no more tax cuts scheduled, the indexation that went into effect this year at least keeps workers whole with respect to inflation and does not push them to bargain for catchup wage increases because they have moved into a higher tax bracket as prices rise.

If this semi-exogenous theory of wage rate determination is true, then wage rate gains will probably remain in the 3% to 4% range indefinitely so long as inflation is not increased by other factors. Thus if wages do not accelerate and the world economy remains far away from full employment and full capacity, any increase in inflation would have to stem from a rise in basic commodity prices due to the devaluation of the dollar. While some effect of this sort will occur, the overall increase in inflation will be only about half as large as usually occurs following a major devaluation of the dollar.

EVANS ECONOMICS FORECASTING SERVICE
FORECAST OF SEPT 23, 1985: FASTER GROWTH THROUGH MID-1986 AND INFLATION STABLE AT 4%

TABLE 1.1 - MAJOR ECONOMIC INDICATORS

Variable Name	1985.2	1985.3	1985.4	1986.1	1986.2	1986.3	1986.4	1987.1	1987.2	1987.3	1987.4	1985	1986	1987
GROSS NATIONAL PRODUCT	3853.1	3918.2	3991.6	4078.1	4158.4	4223.4	4287.1	4342.2	4391.4	4459.6	4527.6	3893.4	4186.7	4430.2
% CHANGE, SAAR	4.5	6.9	7.7	8.9	8.1	6.4	6.2	5.2	4.6	6.4	6.2	6.3	7.5	5.8
GROSS NATIONAL PRODUCT, 1972 $	1671.3	1685.9	1704.0	1725.3	1743.4	1751.3	1760.6	1764.4	1768.3	1779.5	1790.7	1681.2	1745.1	1775.7
% CHANGE, SAAR	1.9	3.5	4.4	5.1	4.3	1.8	2.2	0.9	0.9	2.6	2.5	2.6	3.8	1.8
CONSUMPTION EXPENDITURES	2493.0	2536.3	2559.8	2609.6	2653.9	2703.5	2753.8	2801.0	2850.8	2899.9	2940.9	2508.9	2680.2	2873.2
DURABLE GOODS	339.2	351.0	338.9	347.1	348.5	349.7	353.1	354.0	358.4	363.5	367.1	341.0	349.6	360.7
AUTOMOBILES AND PARTS	157.6	168.9	155.3	162.4	162.0	162.1	162.5	161.5	162.8	165.3	167.2	159.4	162.4	164.2
OTHER DURABLE GOODS	181.6	182.1	183.6	184.7	185.7	187.6	190.6	192.5	195.6	198.1	199.9	181.6	187.1	196.5
NONDURABLE GOODS	891.9	897.1	905.8	916.7	926.9	940.8	954.9	968.8	984.8	997.4	1008.1	893.0	934.8	989.8
FOOD AND BEVERAGES	463.9	465.3	470.8	477.0	482.0	488.7	496.1	502.8	512.3	520.9	528.3	464.3	485.9	516.1
OTHER NONDURABLE GOODS	428.0	431.8	435.1	439.7	444.9	452.1	458.7	466.0	472.5	476.5	479.7	428.7	448.9	473.7
SERVICES	1261.9	1288.1	1315.1	1345.8	1378.6	1413.1	1445.9	1478.2	1507.6	1539.0	1565.7	1274.9	1395.8	1522.6
HOUSING SERVICES	432.9	442.0	452.0	463.4	476.3	489.3	502.1	514.6	524.5	535.9	544.9	437.3	482.8	530.0
OTHER SERVICES	829.0	846.1	863.1	882.4	902.3	923.8	943.8	963.6	983.1	1003.1	1020.8	837.6	913.1	992.7
NEW CAR SALES, SAAR	10.9	11.6	10.5	10.5	10.5	10.4	10.2	9.9	9.6	9.5	9.4	10.9	10.4	9.6
GROSS PRIVATE INVESTMENT	643.2	636.0	676.1	699.6	723.4	721.0	719.9	705.9	693.0	702.7	719.2	650.5	716.0	705.2
FIXED INVESTMENT	625.3	634.4	652.8	668.1	680.1	680.6	679.9	678.8	678.7	686.9	699.7	629.7	677.2	686.0
NONRESIDENTIAL	467.3	474.9	490.1	501.5	512.7	513.6	518.3	522.9	527.7	535.7	546.1	470.8	511.5	533.1
STRUCTURES	168.3	171.6	176.7	180.9	187.3	192.8	196.9	199.9	199.5	202.0	206.8	169.9	189.5	202.0
EQUIPMENT	299.0	303.2	313.4	320.7	325.4	320.7	321.4	323.0	328.3	333.7	339.3	300.9	322.0	331.1
RESIDENTIAL STRUCTURES	158.0	159.6	162.8	166.5	167.4	167.0	161.6	155.9	150.9	151.2	153.6	158.8	165.6	152.9
CHANGE IN INVENTORIES	17.9	1.6	23.2	31.6	43.3	40.4	40.0	27.1	14.3	15.7	19.6	20.9	38.8	19.2
NONFARM	11.4	-2.3	19.4	27.7	39.5	38.4	40.0	27.1	14.3	15.7	19.6	15.7	36.4	19.2
FARM	6.5	3.8	3.8	3.8	3.8	1.9	0.0	0.0	0.0	0.0	0.0	5.2	2.4	0.0
TOTAL PRIVATE HOUSING STARTS	1.77	1.76	1.83	1.81	1.80	1.66	1.61	1.54	1.55	1.61	1.65	1.79	1.72	1.59
NET EXPORTS, GOODS AND SERVICES	-94.0	-84.6	-91.4	-94.0	-97.5	-95.5	-96.3	-94.7	-95.8	-99.6	-103.4	-86.1	-95.9	-98.4
EXPORTS	347.7	349.3	353.7	360.3	369.8	379.7	387.9	395.1	400.6	406.7	413.8	352.9	374.4	404.0
IMPORTS	441.6	433.9	445.1	454.4	467.3	475.2	484.2	489.8	496.3	506.3	517.2	439.0	470.3	502.4
GOVERNMENT PURCHASES	810.9	830.5	847.2	862.9	878.6	894.4	909.7	930.0	943.3	956.6	970.9	820.1	886.4	950.2
FEDERAL	324.2	333.5	339.7	344.9	350.1	355.4	360.7	372.0	377.3	382.6	387.9	329.3	352.8	380.0
NATIONAL DEFENSE	241.1	246.9	253.3	258.7	263.1	267.5	271.9	279.9	284.3	288.7	293.1	243.8	265.3	286.5
OTHER	83.2	86.6	86.4	86.2	87.0	87.9	88.8	92.1	93.0	93.9	94.8	85.5	87.5	93.5
STATE AND LOCAL	486.7	497.0	507.5	518.0	528.5	539.0	549.0	558.0	566.0	574.0	583.0	490.8	533.6	570.2
INDUSTRIAL PRODUCTION, TOTAL	124.2	124.7	127.6	130.0	132.3	132.9	133.6	133.1	132.7	133.5	134.9	125.1	132.2	133.6
% CHANGE, SAAR	1.3	1.8	9.4	7.8	7.4	1.9	2.1	-1.5	-1.3	2.7	4.0	2.7	5.7	1.0
INDUSTRIAL PRODUCTION, MFG.	126.6	127.3	130.6	133.1	135.6	135.8	136.3	135.6	135.2	136.1	137.5	127.6	135.2	136.1
% CHANGE, SAAR	1.9	2.2	10.9	7.8	7.8	0.6	1.4	-1.9	-1.4	2.8	4.2	3.0	5.9	0.7
CAPACITY UTILIZATION, FRB INDEX	80.6	80.5	82.1	83.0	83.9	83.3	83.0	82.0	81.2	81.2	81.5	81.1	83.3	81.5
UNEMPLOYMENT RATE, CIVILIAN	7.3	7.1	7.0	6.8	6.7	6.7	6.8	6.9	7.2	7.2	7.3	7.2	6.7	7.1
FEDERAL GOVT SURPLUS OR DEFICIT	-214.1	-186.3	-184.7	-186.0	-185.0	-189.0	-191.2	-205.8	-212.0	-214.5	-217.6	-187.5	-187.8	-212.5
IMPLICIT GNP DEFLATOR	230.6	232.4	234.3	236.4	238.5	241.2	243.5	246.1	248.3	250.6	252.8	231.6	239.9	249.5
% CHANGE, SAAR	2.6	3.2	3.2	3.7	3.7	4.5	3.9	4.4	3.7	3.7	3.6	3.7	3.6	4.0
CONSUMER PRICE INDEX	321.1	322.9	325.6	329.0	332.3	335.8	338.9	342.0	345.5	348.8	352.0	321.9	334.0	347.1
% CHANGE, SAAR	4.2	2.3	3.4	4.2	4.1	4.2	3.8	3.7	4.1	3.9	3.7	3.4	3.8	3.9
PPI, FINISHED GOODS	293.8	294.1	295.3	296.5	297.9	299.5	301.2	302.5	304.4	306.0	307.5	293.9	298.8	305.1
% CHANGE, SAAR	1.7	0.5	1.6	1.6	1.9	2.1	2.3	1.8	2.5	2.1	1.9	0.9	1.6	2.1
PPI, INDUSTRIAL COMMODITIES	324.8	324.0	325.0	325.8	327.3	328.8	331.1	333.3	335.4	336.9	338.6	324.1	328.3	336.0
% CHANGE, SAAR	2.5	-1.0	1.2	1.0	1.9	1.8	2.7	2.7	2.6	1.8	2.0	0.5	1.3	2.4

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Variable Name	1985.2	1985.3	1985.4	1986.1	1986.2	1986.3	1986.4	1987.1	1987.2	1987.3	1987.4	1985	1986	1987
TABLE 2.1 - FINANCIAL VARIABLES														
MONEY SUPPLY, M1	582.6	606.1	624.6	637.1	648.4	660.1	669.0	677.7	687.6	698.0	707.4	595.3	653.6	692.7
% CHG - ANN COL 18 4Q TO 4Q	10.8	17.1	12.8	8.3	7.3	7.4	5.5	5.3	6.0	6.2	5.5	12.8	7.1	5.7
MONEY SUPPLY, M2	2448.2	2514.1	2576.0	2622.6	2675.9	2713.0	2757.2	2809.2	2862.7	2922.2	2980.1	2488.4	2692.2	2893.5
% CHG - ANN COL 18 4Q TO 4Q	5.5	11.2	10.2	7.4	8.4	5.7	6.7	7.8	7.8	8.6	8.2	9.8	7.0	8.1
FEDERAL FUNDS RATE	7.92	7.92	8.46	9.31	9.14	9.15	8.75	7.92	7.22	6.85	6.68	8.20	9.09	7.17
TREASURY BILL RATE, 91 DAY	7.52	7.08	7.63	8.25	8.16	8.18	7.90	7.33	6.81	6.54	6.41	7.60	8.12	6.77
COMMERCIAL PAPER RATE, 4-6 MO	7.88	7.75	8.41	9.01	8.88	8.89	8.55	7.87	7.28	6.96	6.81	8.16	8.83	7.23
PRIME RATE	10.20	9.50	9.71	10.48	10.60	10.74	10.62	9.79	8.87	8.30	7.96	9.99	10.61	8.73
LONG TERM GOVT BOND RATE, AVG	10.91	10.54	10.95	11.38	11.56	11.71	10.98	10.36	10.04	9.82	9.67	10.96	11.46	9.97
AAA CORPORATE BOND RATE	11.63	11.04	11.49	12.15	12.15	12.31	11.56	10.96	10.64	10.42	10.29	11.61	12.04	10.58
TABLE 2.2 - PERSONAL AND CORPORATE INCOME														
PERSONAL INCOME	3174.7	3199.6	3260.8	3336.9	3401.4	3459.1	3511.8	3564.5	3598.7	3645.3	3692.9	3194.7	3427.3	3625.4
% CHANGE, SAAR	4.0	3.2	7.9	9.7	8.0	7.0	6.2	6.1	3.9	5.3	5.3	6.1	7.3	5.8
DISPOSABLE PERSONAL INCOME	2726.5	2714.7	2766.3	2831.9	2887.0	2936.9	2981.3	3025.3	3053.3	3091.2	3130.7	2715.6	2909.3	3075.1
% CHANGE, SAAR	11.2	-1.7	7.8	9.8	8.0	7.1	6.2	6.0	3.8	5.1	5.2	5.4	7.1	5.7
DISPOSABLE INCOME, 1972 $	1205.3	1192.1	1205.4	1223.2	1235.5	1243.9	1250.6	1256.9	1256.5	1260.1	1264.5	1196.2	1238.3	1259.5
% CHANGE, SAAR	8.2	-4.3	4.6	6.0	4.1	2.7	2.2	2.0	-0.1	1.1	1.4	2.3	3.5	1.7
PERSONAL SAVING RATE	5.1	3.0	3.8	4.1	4.3	4.1	3.7	3.5	2.6	2.2	2.0	4.1	4.1	2.6
CORP PROFITS WITH IVA AND CCA	298.5	314.0	322.8	334.3	345.4	346.4	350.4	351.7	356.5	366.6	376.3	306.9	344.1	362.8
% CHANGE, SAAR	8.8	22.4	11.7	15.1	13.9	1.1	4.7	1.6	5.5	11.8	11.0	7.4	12.1	5.4
CORP PROFITS BEFORE TAXES	221.0	229.9	239.7	253.2	265.5	265.0	268.9	268.3	270.3	275.8	283.0	228.2	263.2	274.4
% CHANGE, SAAR	-2.3	17.2	18.1	24.5	20.9	-0.8	6.1	-0.9	3.0	8.4	10.8	-3.2	15.3	4.3
CORP PROFITS AFTER TAXES	137.4	139.0	143.7	150.9	157.3	155.9	157.2	156.6	157.6	160.8	165.1	139.3	155.3	160.0
% CHANGE, SAAR	1.2	4.7	14.2	21.6	18.0	-3.3	3.2	-1.4	2.6	8.4	11.0	-4.7	11.5	3.0
TABLE 2.3 - GNP COMPONENTS, CURRENT DOLLARS, PERCENT CHANGE, ANNUAL RATES														
CONSUMPTION EXPENDITURES	7.8	7.1	3.8	8.0	7.0	7.7	7.7	7.0	7.3	7.1	5.8	7.1	6.8	7.2
DURABLE GOODS	5.4	14.7	-13.2	10.1	1.6	1.4	4.0	1.1	5.0	5.8	4.1	7.0	2.5	3.2
AUTOMOBILES AND PARTS	5.0	31.9	-28.5	19.7	0.9	-1.6	0.9	-2.3	3.2	6.4	4.6	6.4	1.9	1.1
OTHER DURABLE GOODS	5.7	1.2	3.2	2.5	2.2	4.0	6.7	4.0	6.6	5.3	3.7	7.5	3.1	5.0
NONDURABLE GOODS	6.8	2.4	3.9	4.9	4.5	6.2	6.1	6.0	6.8	5.2	4.4	4.2	4.7	5.9
FOOD AND BEVERAGES	5.9	1.2	4.8	5.4	4.3	5.6	6.2	5.5	7.8	6.9	5.8	4.7	4.7	6.2
OTHER NONDURABLE GOODS	7.8	3.6	3.1	4.3	4.8	6.7	6.0	6.5	5.7	3.4	2.8	3.7	4.7	5.5
SERVICES	9.2	8.6	8.6	9.7	10.1	10.4	9.6	9.2	8.2	8.6	7.1	9.3	9.5	9.1
HOUSING SERVICES	10.5	8.7	9.4	10.5	11.6	11.4	10.9	10.3	8.0	9.0	6.9	9.9	10.4	9.8
OTHER SERVICES	8.5	8.5	8.3	9.3	9.3	9.9	9.0	8.7	8.3	8.4	7.2	9.0	9.0	8.7
GROSS PRIVATE INVESTMENT	-2.2	-4.4	27.7	14.7	14.3	-1.4	-0.6	-7.5	-7.1	5.7	9.8	2.0	10.1	-1.5
FIXED INVESTMENT	13.3	6.0	12.1	9.6	7.4	0.3	-0.4	-0.6	-0.1	5.0	7.6	8.6	7.5	1.3
NONRESIDENTIAL	15.4	6.6	13.4	9.7	9.2	0.7	3.7	3.6	3.8	6.2	8.0	10.6	8.7	4.2
STRUCTURES	13.9	8.1	12.3	9.8	15.1	12.2	8.8	6.1	-0.8	5.2	9.8	13.0	11.5	6.6
EQUIPMENT	16.2	5.8	14.1	9.6	6.0	-5.6	0.8	2.1	6.7	6.8	6.9	9.3	7.0	2.8
RESIDENTIAL STRUCTURES	8.0	4.0	8.3	9.6	2.1	-0.9	-12.4	-13.3	-12.2	0.8	6.3	3.2	4.3	-7.7
EXPORTS	-13.7	1.9	5.1	7.7	10.9	11.1	8.9	7.6	5.7	6.3	7.1	-3.1	6.1	7.9
IMPORTS	6.0	-6.8	10.7	8.6	11.9	6.9	7.8	4.7	5.4	8.3	8.9	2.4	7.1	6.8
GOVERNMENT PURCHASES	9.9	10.0	8.3	7.6	7.5	7.4	7.0	9.2	5.8	5.8	6.1	9.7	8.1	7.2
FEDERAL	5.5	12.0	7.6	6.3	6.2	6.2	6.1	13.1	5.8	5.7	5.7	11.5	7.1	7.7
NATIONAL DEFENSE	12.9	10.0	10.8	8.8	7.0	6.9	6.7	12.3	6.4	6.3	6.2	10.1	5.8	8.0
OTHER	-12.0	17.4	-0.9	-0.9	3.8	4.2	4.2	15.7	4.0	3.9	3.9	15.7	2.3	4.8
STATE AND LOCAL	13.1	8.7	8.7	8.5	8.4	8.2	7.6	6.7	5.9	5.8	6.4	8.6	8.7	6.9

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TABLE 3.1 - GROSS NATIONAL PRODUCT IN CONSTANT DOLLARS

Variable Name	1985.2	1985.3	1985.4	1986.1	1986.2	1986.3	1986.4	1987.1	1987.2	1987.3	1987.4	1985	1986	1987
GROSS NATIONAL PRODUCT	1671.5	1685.9	1704.0	1725.5	1743.4	1751.5	1760.6	1764.4	1768.3	1770.5	1790.7	1681.2	1745.1	1775.7
CONSUMPTION EXPENDITURES	1102.1	1113.0	1115.4	1127.2	1135.0	1145.0	1155.2	1163.7	1173.2	1182.1	1187.0	1105.1	1140.0	1176.7
DURABLE GOODS	190.1	195.3	188.6	192.5	192.6	192.6	193.6	193.7	195.2	197.0	198.1	190.2	192.7	196.0
AUTOMOBILES AND PARTS	79.1	83.0	76.6	79.7	79.4	78.6	78.5	77.9	78.1	78.8	79.4	79.3	79.0	78.5
OTHER	111.2	111.5	112.0	112.6	113.2	115.0	115.0	115.8	117.2	118.2	118.7	111.0	113.7	117.5
NONDURABLE GOODS	403.2	405.5	409.1	412.1	414.4	417.6	420.6	423.5	427.1	429.6	431.2	404.1	416.2	427.8
FOOD AND BEVERAGES	199.8	200.8	203.3	205.2	206.1	207.2	208.3	209.2	211.3	213.2	214.6	200.2	206.7	212.1
OTHER NONDURABLE GOODS	203.4	204.7	205.9	206.9	208.2	210.4	212.3	214.3	215.9	216.4	216.6	203.9	209.4	215.8
SERVICES	508.7	513.0	517.7	522.0	528.0	535.1	541.1	546.6	550.8	555.5	558.6	510.7	531.8	552.9
HOUSING SERVICES	183.9	185.8	187.7	190.0	192.7	195.6	198.3	200.7	202.5	204.7	206.0	184.9	194.1	203.5
OTHER SERVICES	324.8	327.3	330.0	332.0	336.1	339.5	342.8	345.8	348.3	350.8	352.6	325.9	337.8	349.4
GROSS PRIVATE INVESTMENT	289.5	289.0	301.2	309.9	310.2	314.3	312.0	309.0	298.7	301.1	306.2	291.9	313.8	302.7
FIXED INVESTMENT	281.2	284.0	291.0	296.0	299.4	297.1	295.2	293.7	292.8	294.6	298.2	282.3	296.9	294.8
NONRESIDENTIAL	220.3	222.7	228.6	232.5	235.9	234.0	234.4	235.1	236.3	238.3	241.2	221.1	234.2	237.7
STRUCTURES	62.1	62.6	63.9	64.9	66.7	68.2	69.2	69.6	68.8	69.1	70.1	62.3	67.3	69.4
EQUIPMENT	158.2	160.0	164.7	167.6	169.2	165.8	165.2	165.5	167.5	169.2	171.0	158.8	166.9	168.7
RESIDENTIAL STRUCTURES	60.9	61.3	62.2	63.5	63.5	63.1	60.9	58.6	56.5	56.4	57.1	61.1	62.7	57.1
NONFARM	57.9	58.4	59.3	60.5	60.4	60.0	57.7	55.5	53.4	53.3	54.0	58.2	59.7	54.0
FARM	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
PROD DURABLE EQUIPMENT	2.5	2.5	2.5	2.6	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.5	2.7	2.7
CHANGE IN INVENTORIES	8.3	1.0	10.3	13.0	18.0	17.3	16.8	11.3	5.9	6.5	8.0	9.7	16.7	7.9
NONFARM	4.9	-1.0	8.3	11.0	16.9	16.3	16.8	11.3	5.9	6.5	8.0	7.0	15.4	7.9
FARM	3.4	2.0	2.0	2.0	2.0	1.0	0.0	0.0	0.0	0.0	0.0	2.7	1.3	0.0
NET EXPORTS, GOODS AND SERVICES	-33.0	-30.1	-32.6	-34.0	-35.1	-34.0	-35.1	-34.4	-34.7	-35.9	-37.1	-31.2	-34.7	-35.9
EXPORTS	137.9	138.0	139.1	140.8	141.4	145.0	147.8	149.5	150.4	151.7	153.4	139.7	144.5	151.3
GOODS	80.6	80.4	81.2	82.3	81.8	85.5	86.6	87.5	88.4	89.1	90.1	81.7	84.6	88.8
SERVICES	57.3	57.6	57.8	58.5	59.6	60.3	61.1	61.9	62.0	62.6	63.3	58.0	59.9	62.5
IMPORTS	171.0	168.1	171.7	174.9	176.4	180.6	182.9	183.9	185.1	187.6	190.5	170.9	179.2	186.8
GOODS	127.5	121.2	124.4	126.8	129.0	131.3	132.9	133.1	133.5	135.1	136.8	125.2	130.2	134.6
SERVICES	44.2	46.9	47.3	48.1	48.7	49.3	50.0	50.8	51.6	52.6	53.7	45.7	49.0	52.1
GOVERNMENT PURCHASES	313.0	317.2	320.0	322.3	324.6	326.7	328.5	330.1	331.1	332.2	333.7	315.6	325.5	331.8
FEDERAL	129.7	132.0	133.3	134.1	134.9	135.7	136.5	137.3	138.1	138.8	139.5	131.2	135.3	138.4
NATIONAL DEFENSE	94.3	95.9	97.1	98.3	99.0	99.7	100.4	101.0	101.6	102.3	102.9	94.7	99.4	102.0
OTHER	35.4	36.6	36.2	35.8	35.9	36.0	36.1	36.3	36.4	36.5	36.6	36.3	35.9	36.5
STATE AND LOCAL	183.9	185.2	186.8	188.2	189.6	191.0	192.1	192.8	193.1	193.4	194.2	184.2	190.2	193.4

CHASE ECONOMETRICS FORECASTING SERVICE

TABLE 4.1 - GROSS NATIONAL PRODUCT IN CONSTANT DOLLARS , % CHANGE, ANNUAL RATES

Variable Name	1985.2	1985.3	1985.4	1986.1	1986.2	1986.3	1986.4	1987.1	1987.2	1987.3	1987.4	1985	1986	1987
GROSS NATIONAL PRODUCT	1.9	3.5	4.4	5.1	4.3	1.8	3.2	0.9	0.9	2.6	2.5	2.6	3.8	1.8
CONSUMPTION EXPENDITURES	4.9	4.5	0.6	4.5	3.1	3.3	3.6	3.0	3.3	3.1	2.0	4.0	3.2	3.1
DURABLE GOODS	6.8	11.4	-13.0	8.0	0.6	-0.5	2.5	0.3	3.2	3.6	2.3	6.9	1.3	1.7
AUTOMOBILES AND PARTS	7.4	26.2	-30.2	16.7	-1.4	-4.1	-0.2	-3.1	0.8	4.0	2.7	6.7	-0.4	-0.6
OTHER	7.1	0.9	1.8	2.4	2.0	2.1	4.4	2.7	4.0	3.4	2.0	8.5	2.4	3.3
NONDURABLE GOODS	4.7	3.3	3.7	2.9	2.2	3.3	2.9	2.8	3.5	2.3	1.5	2.7	3.0	2.8
FOOD AND BEVERAGES	6.2	3.0	5.1	3.9	1.8	3.1	2.3	1.8	4.0	3.7	3.7	3.5	3.3	2.6
OTHER NONDURABLE GOODS	3.3	2.5	2.5	2.0	2.6	4.3	3.5	3.8	3.1	0.9	0.4	1.9	2.7	3.0
SERVICES	4.2	3.4	3.7	4.0	4.7	4.8	4.6	4.1	3.1	3.5	2.2	4.1	4.2	3.9
HOUSING SERVICES	4.0	4.1	4.3	5.0	5.9	6.0	5.7	5.1	2.6	4.8	2.4	4.0	5.0	4.8
OTHER SERVICES	4.3	3.1	3.3	3.5	4.0	4.1	3.9	3.6	2.9	2.9	2.1	4.1	3.7	3.4
GROSS PRIVATE INVESTMENT	-3.5	-6.1	34.7	12.1	11.1	-6.7	-2.9	-8.7	-8.0	3.3	7.0	0.7	7.4	-3.5
FIXED INVESTMENT	12.6	4.0	10.0	7.3	4.6	-3.0	-2.5	-2.1	-1.2	2.6	5.0	6.5	5.2	-0.7
NONRESIDENTIAL	14.4	4.4	11.1	7.0	6.0	-3.1	0.6	1.2	2.1	3.4	5.0	7.9	5.9	1.5
STRUCTURES	8.8	3.3	8.3	6.6	11.0	9.3	5.5	2.5	-4.5	1.6	6.2	9.7	7.9	3.2
EQUIPMENT	16.7	4.8	12.2	7.1	3.9	-7.8	-1.4	0.7	4.9	4.1	4.5	7.3	5.1	0.8
RESIDENTIAL STRUCTURES	4.1	2.8	6.1	8.6	-0.5	-2.6	-13.1	-14.1	-13.6	-0.9	8.0	1.6	2.6	-8.9
EXPORTS	-15.2	0.3	3.2	5.2	7.3	7.1	5.4	4.7	2.5	3.6	4.5	-4.6	3.4	4.7
IMPORTS	-0.7	-8.1	9.0	7.5	8.5	4.9	5.2	2.2	2.7	5.6	6.2	6.1	4.8	4.2
GOVERNMENT PURCHASES	3.7	4.8	3.6	2.8	2.9	2.6	2.3	1.9	1.3	1.3	1.0	4.6	3.2	1.9
FEDERAL	-0.3	7.4	3.9	2.4	2.5	2.3	2.3	2.5	2.2	2.1	2.2	7.1	3.1	2.3
NATIONAL DEFENSE	7.1	5.0	7.1	5.1	2.9	2.7	2.8	2.5	2.6	2.5	2.5	5.9	4.7	2.6
OTHER	-17.1	13.9	-4.1	-4.7	1.4	1.3	1.0	2.0	0.9	1.1	1.2	10.6	-1.1	1.5
STATE AND LOCAL	6.8	2.8	3.4	3.1	3.2	2.8	2.3	1.4	0.6	0.8	1.5	2.6	3.3	1.7

TABLE 4.2 - IMPLICIT PRICE DEFLATORS FOR GNP (% CHANGE, ANNUAL RATES)

Variable Name	1985.2	1985.3	1985.4	1986.1	1986.2	1986.3	1986.4	1987.1	1987.2	1987.3	1987.4	1985	1986	1987
GROSS NATIONAL PRODUCT	2.6	3.2	3.2	3.7	3.7	4.5	3.9	4.4	3.7	3.7	3.6	3.7	3.6	4.0
CONSUMPTION EXPENDITURES	2.9	2.7	3.1	3.6	3.8	4.2	3.9	3.9	3.9	3.9	3.7	3.0	3.9	3.9
DURABLE GOODS	-1.6	3.0	-0.2	1.9	1.0	1.8	1.4	0.7	1.8	2.1	1.8	0.1	1.2	1.4
AUTOMOBILES AND PARTS	0.0	2.1	2.6	2.5	2.3	2.6	1.0	0.8	2.4	2.3	1.9	1.8	2.2	1.7
OTHER	-1.5	0.3	1.3	0.1	0.2	1.8	2.2	1.2	1.7	1.9	1.6	-1.0	0.6	1.6
NONDURABLE GOODS	2.0	0.1	0.2	1.9	3.3	3.9	3.2	3.1	3.2	3.0	3.8	1.5	1.6	3.0
FOOD AND BEVERAGES	-0.8	-0.6	-0.3	1.4	2.5	3.5	4.0	3.7	3.7	3.1	3.0	1.1	1.3	3.5
OTHER NONDURABLE GOODS	4.7	1.1	0.7	2.3	2.1	2.3	2.3	2.5	2.6	2.6	2.6	1.8	2.0	2.4
SERVICES	4.8	4.9	4.8	5.4	5.2	5.3	4.8	4.9	4.9	4.9	4.8	5.1	5.1	5.0
HOUSING SERVICES	6.2	4.6	4.9	5.3	5.4	5.1	4.9	5.0	4.2	4.6	4.0	5.6	5.1	4.7
OTHER SERVICES	4.0	5.4	4.8	5.4	5.1	5.5	4.8	5.0	5.3	5.3	5.1	4.8	5.2	5.1
FIXED INVESTMENT	0.5	1.8	1.9	2.2	2.7	3.4	2.1	1.5	1.1	2.4	2.5	2.0	2.2	2.0
NONRESIDENTIAL	0.6	2.2	2.1	2.5	3.0	3.9	3.1	2.3	1.7	2.7	2.8	2.5	2.6	2.7
STRUCTURES	4.4	4.6	3.7	3.1	3.0	2.6	3.1	3.5	3.9	3.5	3.3	3.0	3.4	3.4
EQUIPMENT	-0.2	0.8	1.7	2.3	2.1	2.4	2.2	1.4	1.7	2.6	2.3	1.9	1.8	2.0
RESIDENTIAL	1.1	1.6	2.0	0.9	2.6	1.8	0.8	0.9	1.6	1.8	1.4	1.6	1.6	1.4
EXPORTS	1.6	1.9	1.8	2.4	3.3	3.8	3.3	2.9	3.1	2.6	2.5	1.3	2.6	3.1
IMPORTS	7.0	1.7	1.6	1.0	3.2	1.9	2.5	2.5	3.7	2.6	2.5	-3.5	2.2	2.5
GOVERNMENT PURCHASES	6.1	5.0	4.5	4.7	4.5	4.7	4.6	7.2	4.5	4.4	4.3	5.1	4.7	5.2
FEDERAL	6.1	4.0	3.6	3.8	3.6	3.8	3.7	10.3	3.6	3.5	3.4	4.1	3.9	5.3
NATIONAL DEFENSE	5.3	4.8	3.5	3.5	3.9	4.1	3.8	9.6	3.7	3.7	3.6	3.9	3.9	5.2
OTHER	6.5	2.7	3.3	4.0	2.4	2.9	3.2	12.6	3.0	2.7	2.7	5.2	3.4	5.2
STATE AND LOCAL	6.0	5.7	5.1	5.3	5.0	5.2	5.2	5.2	5.2	4.9	4.8	5.0	5.3	5.1

Chairman LaFalce. Thank you, Mr. Evans.
Mr. Sinai.

STATEMENT OF ALLEN SINAI, CHIEF ECONOMIST, SHEARSON LEHMAN BROTHERS, INC., NEW YORK, NY

Mr. Sinai. While I share some near-term optimism over upward revisions in third quarter growth rates indicated by Mr. Evans, I do not find myself feeling quite as comfortable with the current state of the economy and the expansion and its prospects as he does.

The expansion is now entering its 35th month, and I think the negatives of having 5 years of imbalanced domestic fiscal and monetary policies are really very much in evidence. The chickens have come home to roost. It is shown clearly in the performance of the U.S. economy. Years of huge Federal budget deficits and accompanying monetary restraint as an offset to the stimulus of the deficits, extraordinarily high real interest rates, a previously strong dollar and disinflation have induced a sluggishly growing U.S. economy that is very risk prone.

The growing indebtedness in the United States, debt problems of LDC's, huge debt and interest service burden of the Federal Government and what will be a greatly increasing foreign debt internationally, are definitely constraints on growth. The fallout from high interest rates, the strong dollar and disinflation have induced a recession in U.S. manufacturing, a depression in farming, a depression in mining, and that damage is spilling over into other sectors of the economy.

We are fortunate that we have a very robust services sector which I think is what is really carrying the economy forward at this time.

There are numerous imbalances. Unfortunately the U.S. central bank, our main instrument of defusing this situation, is hamstrung because we have still large budget deficits and robust monetary growth despite slow growth in nominal GNP and a sliding economy.

There are record trade deficits and perhaps worse, the growing wave of protectionist sentiment from those parts of the country which are in a lot of pain, and there are many of them.

The current outlook, at best, suggests better growth in the economy over the next four quarters than in the last, which doesn't say too much since we only grew at a 2-percent rate in the last four quarters, with increasing risks of recession from the fallout of the imbalances I have mentioned.

The difficulties that we have seen really are the aftermath of a loose fiscal-tight monetary policy mix in what is now an open economy where we have flexible exchange rates. They have induced crisis management reactions in Washington, for example, the recent G-5 Agreement, and coordinated intervention against the dollar, which can buy us time but not solve the basic underlying problems that face the economy.

We expect growth for real GNP at about 2 percent this year, fourth quarter to fourth quarter, to improve to just below 3 percent in 1986, which should be a better year than this one, and I will explain why we think that.

But that is far less than the administration and Federal Reserve expects. Such growth offers little hope for the problems that beset our economy and the world economies. We would expect inflation to remain relatively low but creep upward to 4 percent and higher in the coming years, mainly from decline in the dollar and some increase in growth.

The unemployment rate will probably rise above the current 7 percent before it begins to decline again but in this case we will not get anywhere near the full employment zone of 5.5 or 6 percent for a long time.

The G-5 Agreement and various other solutions that might arise I regard as third- and fourth-best solutions, as we fail to fully come to grips with correcting the effects of our policy imbalances.

Stopgaps can only delay what could turn out to be a losing battle in sustaining an economic expansion such as this country ought to have given the tremendous weakness we went through in 1980, 1981, and 1982.

The recent data tell us a mixed set of signals on the question of how the economy is doing. If you looked at the data for July you would have concluded the economy was doing abysmally, that it had essentially stopped growing. The data for August were superb, a fine month for the economy. Consumer spending, orders, employment were considerably stronger, inflation news was good. August provided the best month of news we have had probably in a year-and-a-half, since not too long before the November 1984 election, when we had tremendous good news.

In fact, for the third quarter the real economy most likely rebounded more than the Department of Commerce told us in the flash 2.8 percent estimate for real GNP growth. The August improvement in the trade balance and tremendous burst of auto sales, consumer buying which so far in September is at a 15 million unit annual rate for automobiles, an incredible number, tells us that the third quarter, when the data are in, should show 3.5 percent or somewhat more for real GNP growth.

I think what is at issue is the staying power of the rebound.

The bulk of the rebound in the data is coming out of consumer spending and automobiles. I doubt, given the financial position of consumers, the growth of consumption relative to income, and low savings rates, that households will sustain that kind of spending.

They really saw a bargain on automobiles in the cutrate financing, borrowed from the future, from the 1986 automobile purchases to do it in August and September, and we expect consumer spending to be lower in the fourth quarter than in the third.

Also, there are temporary payments from the CCC to farmers in the third quarter which buoy that growth rate. Some of it may be repeated in the fourth quarter, but that only has a transitory effect on real GNP.

The key to the outlook for the next year I think, two keys really, consumer spending and the extent and timing of a turnaround in our trade as a consequence of the falling dollar.

If consumer spending fades and I would think it almost certainly must at some point in the next year given those low savings rates, then it is hard to see why business will spend heavily on plant and equipment if the final sales are not there. Even if the export sector—net exports—turn around and final sales are improved in that area, consumer spending is a driving force, major driving force in terms of our growth.

So for the fourth quarter we would expect less growth, 2.5 percent, reflecting a slowdown in consumer spending and less improvement for net exports than we will see in the third quarter. We could get stronger growth because of a rebound in inventories but that is not a sign of strength in this situation.

That would more likely be a sign of weakness and a response to excess production by automotive manufacturers in terms of disappointing sales in the fourth quarter.

At this stage in the expansion, and it is fairly late in terms of the averages for how long expansions last, one is hard put to find a strong motivating force for steady growth in the 3- to 4-percent range over the next year.

We cannot find it in the outlook for consumer behavior. If you cannot find it there then it is difficult to find in business fixed investment, because it had its boom early this time.

Looking at the Federal Government sector, we do see a shrinking pace of growth in real Federal spending coming out of the budget compromise, and even on the full employment basis, one way of measuring the impact of the budget on the economy after the budget compromise of this summer, even though it didn't fully do the trick, it did do enough so that full employment budget deficits, though high, will shrink and therefore a fading in fiscal thrust.

That throws us into net exports and inventories. Much of the growth we see over the next year comes out of the trade sector. We are looking for recovery or no further deterioration in the tradable goods sectors, as a result of less demand for imports in this country and a response to the very sharp declines in the dollar that have occurred over the past 6 or 7 months.

The kind of growth rate, forecasted reflects a poorly performing and less than optimal performance for the economy. Growth at 2.5 to 3 percent will help keep inflation low, prevent interest rates from moving significantly higher, but really does little to relieve soon the tremendous fallout and difficulties for so many sectors in our economy.

Why is this? I think the current slowdown is really a direct result of imbalances in the monetary fiscal policy mix of the U.S. economy since 1981, set into motion by massive tax reductions which gave us growth, but also huge deficits. That long string of huge deficits, which still remain; record trade deficits; recession in goods-producing sectors of the U.S. economy; and increasing trade debt are all intertwined.

Large Federal budget deficits and monetary growth targeting by the Federal Reserve will produce high interest rates, strengthen the dollar which keeps real interest rates high and strengthens the dollar, et cetera. But we have crowding out in the trade sector as a result of a rising trade debt, and another more negative side to the story. The first part of the impacts of the policy mix, which we saw in 1983-84, explains the tremendous performance of the economy.

The other side is when the trade deficit gets so large that it begins to largely offset the gains coming from consumption and investment and even out of the fiscal policy or fiscal thrust of the Federal Government.

Once a slowdown occurs, then interest rates will drop, the dollar becomes less attractive, the prospects of reinflation increase because of the falling dollar, the dollar then declines more and you get a reverse of the process that occurred before, where dollar strength fed on itself, leading to further increases. You get a cumulative fall in the dollar in this case, and unfortunately slow growth, inflation, squeeze on profits, some improvement in the tradable goods sector but at the expense of the domestic consumption and investment, and you don't have a very nice world. It is a stagnation kind of world, not like the late 1970's but in a smaller dose—slow growth, and inflation rates of 4, 5, 5.5 percent, still high interest rates.

That is the kind of world we really see for the next year or two, absent any further major redressing of the fiscal monetary policy imbalance.

The way to deal with the problems is to tighten the budget further and to ease monetary policy at the same time. That would get at the root of the problems. We have had three doses of tightening the budget and easing monetary policy in the past 4 years, not coordinated, but we have had three doses and each time the economy has gotten a new lease on life.

We had a dose of budget tightening and some easing this year that is helping the economy. But we have not had enough. My fear is that it is going to take more difficulties, which will arise after stopgap measures like the G–5 Agreement fail to work, to once again wake up the policymakers to the fact that you have to go back to reducing the deficits more so that monetary policy can be eased, permitting a much lower profile of interest rates which, in turn, would keep the dollar down, reverse the difficulties that are in the tradable goods sector, and do it without having to resort to intervention or other kinds of crisis management reactions.

What we have in our forecast is middle-of-the-road projections in terms of where the range is in growth, and even that growth is contingent on a number of key policy assumptions. Those include one, that what was done this summer in the budget compromise actually comes to fruition over the fiscal year. That isn't for sure. The President may have to veto some spending bills to make sure that happens. We have viewed the budget compromise as producing nowhere near the savings that were told to us by Congress and the administration. But still, the amount of savings produced in fiscal years 1986 to 1988 takes a significant chunk out of the spending stream.

This year's budget tightening will serve to slow the economy down, and to give the Federal Reserve more leeway. Unfortunately, the budget deficits were not repaired or reduced enough to give the Federal Reserve all the leeway it needs to run a much lower interest rate regime.

We also assume that the Federal Reserve will ease slightly later this year and early next, very slightly, one, because there is more leeway given budget tightening; two, because, at some point, it will take more than intervention to keep the dollar down to the levels the G–5 countries want to see. That assumption is also open to question because the markets are taking the dollar down very rapidly, and the central bank worries very much about a dollar-induced reinflation problem. That makes it harder for the Fed to ease.

We assume no major protectionist legislation coming out of the Congress, that the President's initiatives will neutralize somewhat the recent move toward protectionist legislation. That is a recession risk and it is perhaps somewhat risky to think that we won't have major protectionist legislation with so much going on in the Congress now, unless the U.S. industrial sector quickly shows a sharp improvement.

We assume there will be tax reform along the lines of the administration and the Rostenkowski House Ways and Means Committee revisions. It is neutral for the impacts on economic growth. That is not for sure, because the business provisions could slow economic growth sharply in the first year of passage and push us toward recession. The G-5 intervention should accelerate the decline of the dollar, but the risk here is that without changes in underlying fundamental policies in the United States and rest of the world, it really will do nothing long run that wouldn't have happened otherwise.

Finally, we assume that weakness in the goods sectors still exist but do not drag down the services sectors, which really are carrying the economy. We have two economies out there—the goods economy and the services economy. If you take a weighted average of the economic performance and inflation rates in both of them, you come out with the kind of statistics we have been seeing which I think also explain the mixed signals we get depending on whether we look at industrial data or data that relate to services.

So, in summary, I think we are going to have a long expansion, but it will not be a boomy one unless we do better in our policies. We will muddle through. The slowdown of the past year is helping to lower inflation, lower the dollar, and that is why we can keep expanding. But we don't encourage anyone to look for anything near the kind of performance we had in 1984, and all these uncertainties and risks I have mentioned make us assess the odds on recession at 1 in 4 for some time into the next year.

There is one reason why we should keep expanding; it is that we started from such a weak position. The history of our business cycle is that when the U.S. economy has been driven low and had a severe and deep downturn, recession, or depression, it has a lot of room to grow without developing the excesses that normally give rise to a recession.

And, there is good news in all of these problems that I talked about. The very unusual slowdown in the last year, the trade induced slowdown which raised the risk of recession also has stopped us from crashing against the full employment capacity of the economy quickly which is how we traditionally move into a recession.

I think there is a lot of reason to be optimistic, but not that we will grow in a sustained way enough to lower the unemployment rate. I worry very much about some things going wrong in that whole list of assumptions we have made that underlie our forecast of sustained growth.

[The prepared statement of Mr. Sinai follows:]

Economic Policy and the Prospects for Sustained Expansion

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Economic Policy and the Prospects for a Sustained Expansion

by Allen Sinai*

As the current expansion enters its 35th month, the negatives from five years of imbalances in domestic fiscal and monetary policies have finally come home to roost, impacting negatively on the performance of the U.S. and world economies. Years of huge U.S. federal budget deficits and accompanying monetary restraint to limit inflation, extraordinarily high real interest rates, a strong dollar, and disinflation have produced a risk-prone, fragile, and sluggishly growing U.S. economy. Growing indebtedness in the U.S. private sector, in the LDCs, for the federal government and on international account are restraining expansion. The fallout from a long period of high real interest rates, a strong dollar, and disinflation have produced a recession in U.S. manufacturing, a corporate profits squeeze, and a decline in the market shares of basic U.S. industry vis-a-vis the rest-of-the-world. The U.S. central bank, the usual instrument for defusing the negatives of a slowly growing economy, finds itself hamstrung by the still large budget deficits, surprisingly robust monetary growth despite slow nominal GNP growth, and a sliding dollar. Imbalances--over time, between sectors and industries, across countries, among geographic regions, and between the performance of "goods" sectors and "services" sectors--present a bewildering array of crosscurrents on economic performance. Finally, record trade deficits and the impact on U.S. manufacturing have produced a wave of protectionist sentiment which itself constitutes a major threat to sustained expansion.

These difficulties, the aftermath of a "loose fiscal-tight money" policy mix in an open economy with flexible exchange rates, are sufficiently serious to have produced crisis-management reactions in Washington, both in terms of a dose of budget tightening this year and the G-5 Agreement on coordinated intervention against the dollar. But, so far, these policies have yet to turn the industrial sector of the U.S. economy around.

In this situation, can the economic expansion be sustained? How have economic policies conditioned the performance of the economy and financial markets? What is the current state of the economy? What now is the role of economic policy, domestically and abroad, to sustain the business expansion. What are the impacts, if any, of the recent policy change to reverse dollar strength and the weakness in foreign trade?

The current economic outlook, at best, suggests better growth in the U.S. economy over the next four quarters than the last, but with increasing risks of recession from the fallout of past imbalances in fiscal and monetary policies. Growth for real GNP is expected at 2% in 1985, fourth quarter-to-fourth quarter, and

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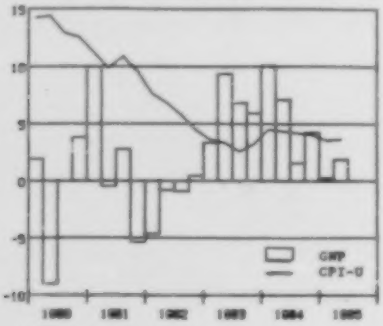
2.9% in 1986, far less than Administration and Federal Reserve expectations. This pace of growth offers little hope for an end to the chronic problems and recession risks that are besetting the U.S. and world economies. Inflation rates, while low, around 3% or so, will come under upward pressure in 1986 and beyond. The unemployment rate may yet rise from the current 7% and, in any case, is not likely to decline much. Pressure on corporate profits is likely to continue. And, the split performance of goods vs. services activities seems set to continue.

Third and fourth best solutions to the problems stemming from large federal budget deficits, the strong dollar, chronic trade deficits, slow economic growth and sectoral imbalances, such as the recent G-5 Agreement, seem likely. But, although some signs of improvement should appear, the problems are far from solved. Without a further correction of the unbalanced mix of monetary and fiscal policy, stopgap solutions such as the recent G-5 Agreement can only delay what could be a losing battle in sustaining the economic expansion.

The U.S.Economy--Recent Performance

After a superlative performance for 1983 and much of 1984, the performance of the U.S. economy has been deteriorating over the past year. From the fourth quarter of 1982 to mid-1984, the economy grew at a 7.1% pace. Since mid-1984, real economic growth has declined to 2%, well below potential growth of 3%. During the first half of 1985, real economic growth was only 1.1%. Between November 1982 and November 1984, the unemployment rate dropped from 10.7% to 7.1%. Since November 1984, the unemployment rate has hardly budged, falling from 7.1% to 7.0%. Between November 1982 and August 1984, industrial production rose by 22.8%. In the past year, industrial production has risen only 1.1%. Between November 1982 and July 1984, the factory utilization rate rose from 70% to 82%. In the past year, the total factory utilization rate has dropped from 82% to 80%. Between the fourth quarter of 1982 and the third quarter of 1984, business fixed investment rose $48 billion or 29.7%. Since last year, business spending on plant and equipment has risen at a 11.0% rate. Since the fourth quarter of 1982, real net exports have declined $57.5 billion. For the five other expansions that have lasted this long, the average change in net exports was $2.3 billion. Between November 1982 and currently, manufacturing employment has declined by 0.8%; mining employment is down 6.5%; and agricultural employment has dropped 11.2%. Services employment, on the other hand, has grown robustly, rising by 7.2 million persons since the expansion began. A split personality has developed for the U.S. economy, with essentially a recession in goods-producing industries but a near boom in services. The dichotomy in behavior also appears by region, over time, and across countries. After an extraordinary rise of 54.9% from July 1980 to March 1985, the dollar is now declining sharply, raising the potential for higher inflation in coming months. From 1982:4 to mid-1984, aftertax corporate profits rose a large 49.4%; since last year, aftertax corporate profits are down by 8.3%. Between the fourth quarter of 1982 and mid-1984, real disposable income rose 9.2%. Since last summer, real disposable income is up by only 3.4%. Finally, over the past year, the U.S. economy has exhibited a growth recession, growing more slowly than potential output in three of the past four quarters.

Chart 1
GNP and Inflation*
(Percent Change, Quarterly, 1980 to 1985:2)



*Change is year-over-year.

Table 1
Performance of the U.S. Economy, By Sector

	Change Since 1982:4		Average Change* of 5# Previous Expansions	
	Billions of Constant Dollars	Percent Change	Billions of Constant Dollars	Percent Change
Real Gross National Product	192.5	13.0	115.9	3.5
Consumption	125.7	12.9	65.6	2.3
Investment	111.7	62.8	41.3	7.1
Fixed Investment	78.8	38.9	7.4	3.4
Nonresidential	58.8	36.4	5.6	9.0
Residential	20.1	49.3	1.8	3.9
Inventories	32.9	NM	3.9	NM
Government	12.9	4.3	6.7	3.3
Federal	4.9	3.9	-1.7	-1.8
State & Local	8.1	4.6	8.5	8.0
Net Exports	-57.9	-240.3	2.3	20.0

NM=Not Meaningful

* Change is over ten quarters following each trough.

The 1980-81 expansion was excluded because its duration was less than ten quarters and 1949-53 was dropped as atypical.

Table 2
"Growth Recessions" in the Postwar Period[a]

Dates	Quarters Into Expansion	Growth	Recession (R) or Continued Expansion (E)	Quarters Until Recession
1951:4 to 1952:2	8	0.8, 3.2, 0.4	R	5
1956:1 to 1956:3	7	-1.6, 2.1, 0.3	R	2
1967:1 to 1967:2	25	0.5. 2.6	E	11
1973:2 to 1973:3	10	0.5, 2.6	R	1
1976:2 to 1976:3	5	2.7, 2.3	E	14
1984:3 to 1985:2	10	1.6, 4.2, 0.3, 1.9 (Average, 2.0)	?	?

[a]Two or more quarters of less-than-potential growth in GNP.

These patterns are highly unusual for a business expansion, which usually starts slowly, gathering speed to eventually bring on inflation from excessive aggregate demand, then tight money, and a downturn. Is the expansion fizzling out?

Recent data present a mixed set of signals on this question. The data for July were almost uniformly bad, but the data showed that August was a strong month. Consumer spending, durable goods orders, and employment, especially in services, were considerably stronger. But, at the same time, the industrial sector of the economy continued to show only small signs of ending its long period of deterioration.

In the third quarter the real economy rebounded more than was suggested in the "flash" estimate of the Department of Commerce. Data since the report show a better trade balance than was assumed. Strong auto sales indicate more consumption than probably had been estimated. But inventories probably were lower. The net result should be a growth rate of about 3-1/2%.

At issue is the staying power of this rebound. First, the bulk of the increase occurred in consumption spending and federal government purchases. The Commerce report on consumption for August indicated a surge in durable goods spending from much higher auto sales. Since the burst of auto sales likely resulted from temporary cut-rate financing, consumption spending rose much faster than income and the savings rate dropped to a 25-year low, it is likely that consumer spending will fade significantly in the fourth and first quarters. The increase of government purchases was buoyed by a big increase for Commodity Credit Corporation payments to farmers and also might be transitory.

Second, little change has been estimated for business fixed investment, a distinct negative for the economy. If consumption spending should fade in the fourth quarter and beyond then it is hard to see how business fixed investment can improve much.

Finally, inventory accumulation was down in the third quarter compared with the second, undoubtedly the result of a destocking of auto inventories. Since 1986 auto sales have been borrowed against in exchange for third quarter sales, auto makers may well be caught with excess inventories in relation to sales in the new model year, having to cut back later.

For the fourth quarter, growth is likely to weaken to about a 2-1/2% pace, reflecting the slowdown in consumer spending and less improvement for net exports, if any, compared with the third quarter. Stronger growth may well be generated by a rebound of inventories, but this would be a sign of weakness rather than strength, especially if the inventories were built up in the automotive sector.

As Table 3 shows, consumers are heavily in debt, with outstanding debt relative to income at postwar highs and delinquency rates on mortgage and installment credit having moved sharply higher. With the consumer saving rate below 3%, some retrenchment is inevitable. What is keeping household spending and borrowing up appears to be still reasonable monthly loan repayments, both for mortgages and auto loans, relative to income, compared with historical experience.

Table 3
Consumer Behavior: Financial Indicators

	Quarters			Years*			
	1988:3F	1988:2	1988:1	1986	1980	1970	1960
Consumer Indebtedness							
Consumer Credit, Total**	672.2	644.0	616.7	560.1	350.1	161.5	63.6
(% change, annual rate)	18.7	20.5	560.3	9.2	10.5	11.8	--
(as a % of disposable income)	24.0	23.6	23.2	21.3	21.1	20.3	18.1
Installment Credit	540.0	517.1	493.0	517.1	311.2	106.1	43.0
(% change, annual rate)	18.0	21.0	22.4	13.8	11.6	9.0	--
(as a % of disposable income)	19.0	19.0	18.6	17.0	17.0	15.0	12.8
Other Consumer Credit	132.2	127.0	121.6	100.9	73.0	57.2	19.7
(% change, annual rate)	17.6	18.7	20.7	10.4	7.1	6.6	--
(as a % of disposable income)	4.9	4.7	4.6	4.3	4.5	5.3	5.6
Home Mortgages	1460.1	1407.7	1372.0	1281.3	930.0	294.0	133.1
(% change, annual rate)	12.3	10.5	9.0	8.3	12.6	7.0	--
(as a % of disposable income)	53.4	51.6	51.7	49.7	50.0	41.0	37.8
TOTAL	2131.3	2051.7	1987.6	1820.4	1310.0	455.2	196.6
(% change, annual rate)	16.3	13.6	13.0	8.6	11.0	8.0	--
(as a % of disposable income)	78.2	75.3	74.9	71.0	71.5	61.3	55.9
Debt Service							
Mortgage Repayments ($ per month)	700	729	730	703	584	160	84
(as a % of median family income)	20.0	21.1	22.1	21.9	22.5	17.0	16.0
Newly-Built Homes							
Fixed Rate	630	705	719	684	--	--	--
Adjustable Rate	603	649	680	630	--	--	--
Existing Homes							
Fixed Rate	610	628	624	616	--	--	--
Adjustable Rate	570	581	590	590	--	--	--
Auto Loan Repayments ($ per month)	250	262	263	283	183	161	--
(as a % of median family income)	10.5	10.3	10.0	11.5	10.8	18.6	--
Interest Payments on Installment Credit as a % of Disposable Income	3.4	3.3	3.3	3.2	2.0	1.6	1.1
Interest Payments on Mortgages as a % of Disposable Income	7.2	7.2	7.2	7.3	5.6	3.0	2.8
Interest Payments on All Debt as a % of Disposable Income	10.6	10.5	10.4	10.4	8.1	5.2	3.8
Delinquency Rates							
Installment Credit (%)	2.20	2.33	2.26	1.98	2.61	--	--
Mortgages (%)	0.40	0.30	0.10	1.08	0.80	0.88	--
Other Household Measures							
Financial Assets/Liabilities	290.0	290.8	282.3	281.4	337.7	360.0	396.8
Real Financial Assets	2334.1	2302.2	2269.8	2107.3	1811.0	1068.1	1080.7
(% change, annual rate)	5.7	9.6	10.3	4.8	1.8	3.6	--
Net Worth (net of depreciation)	12390.0	12162.0	11901.2	11680.0	8833.0	3171.0	1701.7
(% change, annual rate)	8.4	8.5	10.4	6.0	10.9	6.1	--
Real Net Worth (net of dep'n)	5636.2	5387.6	5321.1	5233.6	4763.5	2847.8	2611.8
(% change, annual rate)	5.1	3.8	6.0	2.4	4.0	2.0	--

F=Shearson Lehman Brothers forecast.

*Percent change is as of the previous indicated year, at an annual rate.

**Consumer credit includes short- and intermediate-term installment and noninstallment credit extended to individuals through regular business channels to finance the purchase of consumer goods and services.

Why is the Economy Now Performing So Poorly?

The current slowdown is a direct result of imbalances in the monetary-fiscal policy mix of the U.S. economy since 1981, set into motion by massive tax reductions. The resulting long string of huge U.S. federal budget deficits, record trade deficits, recession in goods-producing sectors of the U.S. economy, and increasing trade debt are intertwined. Large federal budget deficits, in the context of monetary growth targeting by the Federal Reserve, stimulate economic growth and raise nominal and real interest rates. Higher interest rates strengthen the dollar. A stronger dollar holds down inflation and raises real interest rates. The dollar is further strengthened. With strong economic growth and a strong dollar, imports increase and the pace of exports decreases. A worsening trade deficit and an increased trade debt result. So long as the huge federal budget deficits remain, the process continues until the trade sector becomes so weak that economic growth slows, interest rates drop, the dollar declines, and the process is reversed. However, with no intervention to tighten the budget, the eventual result is a lopsided, unbalanced economy, with numerous problems--including chronic federal budget deficits, an overvalued domestic currency, permanent erosion in the relative market shares of the basic industrial sector and industries, stagnant economic growth, high unemployment, still too high inflation, high real interest rates, and a fallout of failures in beleaguered sectors, industries, and financial institutions.

The way out of the current malaise is to redress the unbalanced policy mix that exists. Indeed, a dose of budget tightening and an easing of monetary policy did take place this year, the third correction to the policy mix problem in the last four years. In 1982, the Tax Equity and Fiscal Responsibility Act (TEFRA) was implemented and monetary policy eased. During 1984, the Deficit Reduction Act (DEFRA) was passed and during the second half the central bank eased. In each of these instances, the twist in the policy mix away from a loose fiscal-tight money combination toward a tighter fiscal-easier money combination was carried out in response to a near crisis and not coordinated. In 1982, the problem was that the economy remained in recession. In 1984, the difficulty was a surprising rise in interest rates and weak growth in the second half. This year, the crisis lies in the too high dollar and growing decline of the tradable goods sector in the U.S. economy.

Table 4
Comparison of Savings From Deficit Resolution
Packages in Recent Years*
(Billions of Dollars, Fiscal Years)

	Year 1	Year 2	Year 3	Total
1982, TEFRA	21.7	43.6	50.6	115.5
1984, DEFRA	10.6	16.5	22.5	49.5
1985, Reconciliation Act (Anticipated)	17.8	22.5	30.5	70.8
1985, Reconciliation Plus Defense	20.7	34.2	51.1	106.0
1985, Bona Fide Savings Except Debt Service	19.4	36.6	49.0	105.0

*Shearson Lehman Economics

But, not enough was done in this year's budget tightening. Shearson Lehman Economics estimates that the budget savings of the First Concurrent Resolution were overstated and deficits underestimated. Instead of $55.5 billion of savings in FY1986, only $21 billion of bona fide savings actually will occur. Rather than the $276.2 billion of savings indicated in the budget resolution, only $132.6 billion of bona fide savings are in place. Taking realistic account of the legitimate savings in the budget resolution and using more realistic economic assumptions than the Administration and Congress provides projections of deficits that range from $202.3 billion in FY1986 to $173.6 billion in FY1988. The Administration estimates are $171.9 billion in FY1986 and $112.9 billion in FY1988. More deficit reduction is thus necessary to establish conditions that can fundamentally lead to a resolution of those factors responsible for the poor performance of the U.S. economy.

Table 5
Bona Fide Budget Savings*
(Fiscal Years, Billions of Dollars)

	1986	1987	1988	Total
Budget Resolution	55.5	90.9	130.7	276.2
Nondefense	25.3	35.4	47.9	108.6
Defense	27.5	45.2	64.6	137.3
Debt Service	2.7	9.4	18.2	30.3
Questionable Savings	34.5	45.7	67.3	147.5
Nondefense	9.5	10.8	18.6	38.9
Defense	24.6	33.5	45.9	104.0
Debt Service	0.4	1.4	2.8	4.6
Savings	21.0	44.3	67.3	132.6

*Shearson Lehman estimates.

Table 6
Congressional Budget Resolution: Deficits and Assumptions*
(Fiscal Years, Billions of Dollars Except as Otherwise Indicated)

	1985	1986	1987	1988
Revenues	736.5	795.7	869.4	960.2
Outlays	946.3	967.6	1024.1	1073.0
Deficits	209.8	171.9	154.7	112.9
Deficits/GNP (Percent)	5.0	3.8	3.1	2.3
Economic Assumptions				
Real GNP (Percent Change)	4.0	4.0	4.0	4.0
Implicit GNP Deflator (Percent Change)	3.6	4.3	4.2	4.0
Unemployment Rate (Percent, FY Average)	7.0	6.9	6.7	6.4
91-Day Treasury Bills (Percent)	7.6	7.5	7.0	5.9
Long-Term Government Bond (Percent)	11.3	10.5	9.7	7.8

*Estimates contained in the concurrent resolution and the conference agreement.

Table 7
Shearson Lehman Budget Projections and Assumptions
(Fiscal Years, Billions of Dollars Except as Otherwise Indicated)

	1985	1986	1987	1988
Revenues	737.0	774.0	844.5	941.6
Outlays	943.9	976.3	1037.0	1115.2
Deficits	206.9	202.3	192.5	173.6
Deficits/GNP (Percent)	5.4	4.9	4.3	3.6
Economic Assumptions				
Real GNP (Percent Change)	2.4	2.9	3.5	4.1
Implicit GNP Deflator (Percent Change)	3.7	3.9	4.8	5.3
Unemployment Rate (Percent, FY Average)	7.4	7.2	7.0	6.8
91-Day Treasury Bills (Percent)	7.5	7.4	7.5	7.8
Long-Term Government Bond (Percent)	11.2	10.5	10.8	11.1

Table 8
Deficit Prospects: Reconciliation of Concurrent
Budget Resolution and Shearson Lehman Projections
(Fiscal Years, Billions of Dollars)

	1985	1986	1987	1988
First Concurrent Resolution	209.8	171.9	154.7	112.9
Overstated Nondefense Savings*		9.9	12.2	21.5
Economic Reestimates*		20.5	25.6	39.2
Deficit Prospects*	209.8	202.3	192.5	173.6
Percent of GNP	5.5	4.9	4.3	3.6

*Shearson Lehman Economics estimates and forecast

The budget compromise is a case of a half empty-half full cup of wine situation. It was better than no compromise at all, but insufficient to fully resolve the problem of the deficits. A significant tightening of the budget was accomplished, with $21 billion of bona fide spending cuts in FY1986, $44.3 billion in FY1987, and $67.3 billion in FY1988, but not enough to permit a full rebalancing of the unbalanced policy mix that is at the heart of the current difficulties of the U.S. economy. The budget deficits are now on a declining path, and federal government spending, in real terms, will grow far more slowly in future years, about two percentage points or so less than if there had been no compromise. But the structural deficits still remain to keep interest rates higher, the dollar stronger, the trade deficit weaker, and trade debt increasing by more than otherwise.

The move toward protectionism in the U.S. is another outgrowth of the failure to correctly align fiscal and monetary policies. So long as real interest rates and the dollar remain high, the U.S. industrial sector will keep losing market share, with all of its attendant failure fallout. Rising protectionist sentiment is a natural consequence of the squeeze on the U.S. industrial sector. Rather than defusing protectionism by a stopgap policy market intervention such as is embodied in the G-5 Agreement, it would be far better to tighten the budget and ease monetary policy.

Indeed, the G-5 Agreement is an example of a policy reaction that is being fostered on the world economy as a third or fourth best reaction to deal with the strong dollar and weak trade.

The G-5 Agreement between the United States, Great Britain, Japan, France, and Western Germany to lower the dollar was an attempt to 1) head off the many negative side effects of a too high dollar, 2) sustain the expansion in the United States and the rest of the world, and 3) stem the rising tide toward protectionism. Intervention to lower the dollar through coordinated actions in foreign exchange markets, though interfering with freely fluctuating exchange rates, is the lesser of two evils, when compared with protectionism, in dealing with a strong dollar and chronic trade deficits.

The political motivation of the United States, who called the meeting, was apparent. Growth in the U.S. economy is far below Administration expectations--mainly from the strong dollar and effects related to the trade deficit-- and is a big problem as the 1986 political year approaches. The move toward protectionist legislation in the Congress forced the President's hand, who now is supporting interventionist action to stave off more pronounced departures from free trade, such as import quotas, tariffs, or surcharges.

A sustained and orderly decline in the dollar--if it could be engineered--would improve net exports, increase economic growth domestically and abroad, stop the declines of commodity prices, and push up corporate profits. Protectionist legislation that could interfere with world trade and financial flows also might be defused. Dollar declines, however, while good for economic growth and profits, do risk reinflation. Any decline must be gradual, which is difficult since markets usually do not move in that manner.

A key is how the dollar decline is engineered. If through currency market intervention alone--initially the most likely approach of the G-5 countries--the effects generally are only transitory unless the intervention is in the direction dictated by dollar fundamentals. Since the fundamentals of the dollar suggest reductions anyway, the G-5 agreement should hasten and intensify the declines of the dollar. But, whether there will be any lasting effects from intervention alone, other than what would have happened anyway, is open to question.

If a dollar decline were to be engineered through an easing of monetary policy--an unlikely initial approach for the U.S. central bank--the reductions in the value of the dollar would be more orderly. Lower interest rates could accelerate economic growth in a more balanced fashion, and more rapid growth can offset the negatives for the dollar of lower interest returns. The rest of the world could then follow suit toward lower interest rates, bringing about lasting declines of real interest rates--the ultimate basis for a sustained revival of growth in the United States and elsewhere. But currently the Federal Reserve cannot ease and will prefer to let intervention or its threat work on the dollar, interest rates, and equity prices through the financial markets. The central bank faces the same dilemma as before--what to do about monetary policy in the face of weak economic growth and explosive monetary growth--and is more likely to let market forces move the dollar and interest rates than to aggressively reduce interest rates through an easier monetary policy.

If shifts in the relative fiscal policies of the major countries were instituted, with easier fiscal policies abroad, this could also work to bring about a dollar decline. But such action is very risky because of the potential for precipitating a dollar collapse. Here, funds might not only leave dollar-denominated assets but seek expected appreciation in countries where fiscal policy was becoming more stimulative.

Finally, further budget deficit reductions in the United States are a means to a lower dollar. But all that can happen has happened already this year and has been reflected in the financial markets. The G-5 Agreement only reaffirmed that the United States would do what is in the current budget resolution and did not indicate any additional actions forthcoming to reduce the deficits.

In all cases, a dollar decline from any source is quite risky, chancing a significant reinflation. There is also the risk that foreign holders of dollars would move out of the U.S. currency, precipitating a dollar collapse, or that the policymakers will not let the lags between dollar declines and improved trade work themselves out.

The action being taken represents a way to reflate without necessarily easing U.S. monetary policy, which cannot be done with monetary growth so rapid at the current time. But it also is a political matter--probably moreso. Fundamentally, the right action is to rebalance the unbalanced mix of monetary and fiscal policy by reducing the U.S. federal budget deficit further.

The Pluses of the Economic Slowdown

The economic slowdown has not been all bad; indeed, probably enhancing the possibility of sustained, albeit subpar, growth. By-products include lower inflation, lower interest rates, and a lower dollar. The growth recession has opened up more slack in the economy, adding to downward pressure on prices and wages. Also, ample supplies of food commodities and less demand for oil imports have helped to drive prices down. The slowdown has been associated with lower interest rates, as demand-side forces brought about declines and periodic easings of monetary policy were required. Finally, a lower dollar is a consequence of slow growth and the reductions of interest rates that occurred.

Lower inflation enhances household and business purchasing power; lower interest rates increase the affordability of household durable goods and reduce the costs of financing; and the lower dollar should, with lags, act to reduce imports and enhance exports. All of these are necessary in order for the expansion to be sustained.

Chart 2
Consumer Price Index
(Percent Change, Year-Over-Year,
Monthly, 1975 to 1985)

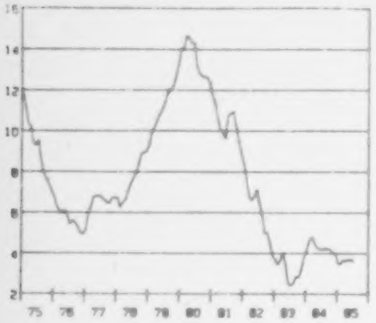
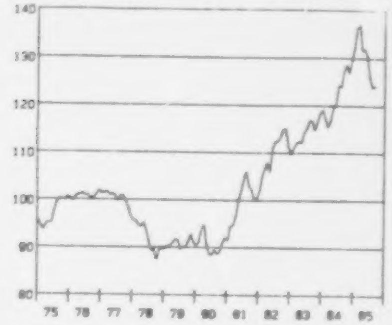


Chart 3
Trade-Weighted Dollar*
(Index, 1980-1982 = 100, 1975 to 1985)



* Weighted by the bilateral trade shares of fifteen OECD U.S. trading partners.

Source: Morgan Guaranty

Chart 4
Prime Business Lending Rate
(Percent, 1975 to 1985)

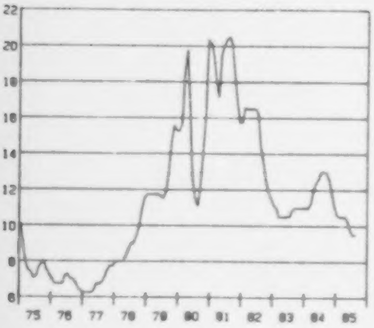
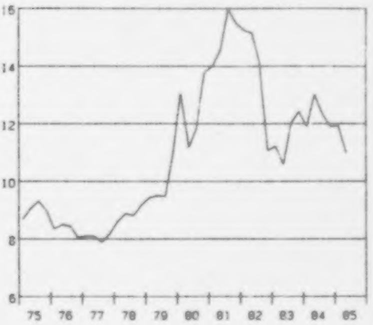


Chart 5
New Issue Corporate Bond Rate*
(Percent, 1975 to 1985)



*AAA-equivalent.

The Economic Outlook

The Shearson Lehman Brothers economic forecast presents a "muddling-through" scenario for the next couple of years. The expansion should continue, getting a second wind from lower inflation, lower interest rates, and a lower dollar. If all else fails, the central bank will step in to keep the economy expanding. The harmful effects of recession in the U.S. and world economies far outweigh the risk of reinflation. Sustained growth is likely, but probably subpar in 1985 and 1986, with a one-in-four risk of recession. The reduced inflation, lower interest rates, lower dollar, and accommodative Federal Reserve policy envisioned do not insure growth in the 3% to 4% range and a gradual decline of unemployment, however. More of a fundamental correction in the policy mix is required. A shift in the profile of spending, still low inflation, better corporate profits, slower monetary growth, somewhat lower interest rates, and declining budget deficits characterize the projections.

For the rest of this year, growth is relatively weak, declining from the third quarter because of reduced auto sales and weaker household spending. For the next year, an improvement in net exports is expected to contribute most to improved growth, with only modest increases for consumption spending and business fixed investment. Housing and residential construction remain firm, but do not rise much. Business keeps inventories lean in relation to sales. And, federal government spending eases off to a 3.1% annual rate, compared with the 8.7% of 1985.

Inflation rates fluctuate between 3% and 3-1/2%, tilting upward as 1986 progresses from the lagged effects of a lower dollar.

The dollar drops another 10% or so from current levels over the next year, reflecting negative fundamentals and periodic intervention by the G-5 countries.

Profits do better in 1986 than 1985, rising by about 7% because of cost-cutting, earnings translation under a weaker dollar, and improved sales.

Monetary growth moves to within target ranges for the next year and interest rates are stable to somewhat lower. Stock prices enjoy a modest rise as a result.

How can the expansion continue? Essentially, lower interest rates and a lower dollar help stimulate the tradable goods sector which, in turn, benefits U.S. producers. Lower inflation sustains the real purchasing power of households and business and spending continues to rise, although only modestly. When necessary, the central bank steps in with a slight easing but increasingly as the expansion wears on, the central bank finds itself unable to provide strong doses of ease.

This relatively sanguine forecast of sustained growth depends on a number of critical assumptions, most having to do with economic policy.

Table 9
Shearson Lehman Economic and Financial Markets Forecast
September 26, 1985
(Probability=0.65)

	Quarters						Years				
	1985:2	1985:3	1985:4	1986:1	1986:2	1986:3	1984	1985	1986	1987	1988
Gross National Product-1972 Dollars	1671.3	1686.7	1696.6	1707.0	1722.2	1736.7	1639.3	1679.0	1727.5	1790.4	1863.1
Annual Rate of Change	1.9	3.5	2.3	2.7	3.6	3.2	6.8	2.4	2.9	3.6	4.1
Percent Change Year Ago	2.0	2.5	2.0	2.6	3.0	3.0	6.7	2.0	2.9	4.2	3.8
Consumption	1102.1	1114.3	1116.2	1121.0	1125.5	1131.3	1062.4	1105.4	1128.8	1169.8	1212.9
Annual Rate of Change	4.9	4.5	0.7	1.7	1.6	2.1	5.3	4.0	2.1	3.6	3.7
Business Fixed Investment	220.3	220.6	222.8	226.0	228.2	230.9	204.9	219.2	229.6	238.8	253.2
Annual Rate of Change	14.4	0.5	4.0	5.9	4.0	4.8	19.8	7.0	4.8	4.0	6.0
Residential Construction	60.9	60.8	61.5	62.1	61.7	61.3	60.2	60.8	61.8	63.6	66.5
Inventory Investment	8.3	1.2	3.8	6.0	9.1	7.6	24.8	8.1	7.0	5.8	9.0
Net Exports	-33.8	-31.5	-30.9	-29.7	-26.1	-19.3	-15.0	-31.2	-22.9	-14.8	-9.8
Government-											
Federal	129.7	135.8	137.2	136.4	137.9	137.7	122.5	133.1	137.2	138.9	140.2
Annual Rate of Change	-0.3	20.2	4.2	-2.3	4.5	-0.6	5.4	8.7	3.1	1.2	0.9
State and Local	183.9	184.5	184.9	185.2	185.9	186.2	179.6	183.6	186.1	188.5	191.0
Annual Rate of Change	6.8	1.3	0.9	0.7	1.5	0.6	2.2	2.2	1.4	1.3	1.3
Industrial Production (1977=1.000)	1.242	1.246	1.256	1.271	1.288	1.295	1.218	1.245	1.289	1.347	1.420
Annual Rate of Change	1.4	1.2	3.2	4.9	5.5	2.2	11.6	2.2	3.5	4.5	5.4
Housing Starts (Mil. Units)	1.772	1.721	1.746	1.703	1.706	1.704	1.767	1.758	1.760	1.820	1.905
Auto Sales-Total (Mil. Units)	10.9	12.4	9.8	10.5	10.6	10.7	10.4	11.0	10.7	10.9	11.1
Unemployment Rate-Civilian (%)	7.3	7.2	7.2	7.0	6.9	6.8	7.5	7.3	6.9	6.8	6.6
Federal Budget Surplus											
Unified (Quarterly Rate, NSA, FY)	-30.8	-45.8	-56.5	-68.3	-36.4	-41.1	-185.3	-206.9	-202.3	-192.5	-173.6
Implicit Price Deflator (%CH)	2.6	3.1	3.0	3.4	3.9	4.4	3.8	3.5	3.6	4.7	5.3
CPI- All Urban (%CH)	4.2	2.4	2.5	3.6	4.0	4.3	4.3	3.4	3.5	4.9	5.1
PPI-Finished Goods (%CH)	2.3	.0	2.4	3.1	3.5	3.6	2.1	0.9	2.7	4.8	5.1
Trade Weighted Exchange Rate	1.313	1.250	1.188	1.121	1.063	1.008	1.223	1.276	1.048	0.975	0.985
Annual Rate of Change	-10.8	-17.9	-18.4	-20.7	-19.1	-19.1	7.1	4.3	-17.9	-6.9	1.0
Corporate Profits Aftertax (Bils. $)	137.4	139.6	140.9	143.7	147.1	150.3	145.9	138.7	148.6	160.5	176.4
Percent Change Year Ago	-8.5	-1.5	-0.1	4.9	7.1	7.7	14.5	-4.9	7.1	8.0	9.9
Adjusted Profits Aftertax (Bil. $)	214.9	216.9	218.2	220.7	224.1	229.3	195.9	214.3	227.1	244.0	266.4
Percent Change Year Ago	10.1	8.6	7.0	6.6	4.3	6.7	31.1	9.4	6.0	7.4	9.2
Real Disposable Income	1206.3	1193.2	1199.4	1207.7	1217.0	1224.3	1169.0	1195.0	1219.9	1263.7	1319.9
Annual Rate of Change	8.2	-4.0	2.1	2.8	3.1	2.4	6.7	2.2	2.1	3.6	4.4
Personal Saving Rate (%)	5.1	2.9	3.2	3.3	3.6	3.6	6.1	3.9	3.5	3.6	4.0
M1 (Bils. $)	582.6	603.5	612.8	617.8	628.0	637.7	553.5	612.8	646.4	684.6	733.6
Annual Rate of Change	10.6	15.1	6.3	3.3	6.7	6.3	5.2	10.7	5.5	5.9	7.2
M2 (Bils. $)	2448.2	2510.2	2553.2	2598.9	2647.6	2697.9	2346.8	2563.2	2774.3	2936.7	3162.1
Annual Rate of Change	6.4	10.5	7.0	7.0	8.0	7.8	7.7	8.8	8.7	5.8	7.7
Federal Funds Rate (%)	7.92	7.88	7.30	7.26	7.58	7.80	10.23	7.92	7.56	7.86	8.04
Prime Rate (%)	10.20	9.50	9.25	9.00	9.25	9.00	12.04	9.87	9.47	9.82	10.42
New Top Quality Corporate Bonds (%)	11.78	11.29	11.25	10.84	11.06	11.21	12.44	11.67	11.14	11.26	11.32
30-Year Treasury Bond Rate (%)	10.98	10.56	10.34	10.15	10.37	10.46	12.39	10.86	10.38	10.66	10.91
Bond Buyer Index (%)	9.02	9.06	9.03	8.84	8.96	9.05	10.09	9.19	8.99	9.02	9.06
S&P Index of 500 Common Stocks	184.80	186.30	186.22	188.21	190.25	193.40	160.43	184.16	192.44	205.60	221.50
Annual Rate of Change	18.0	7.8	-4.3	4.3	4.4	6.8	.0	14.8	4.5	6.8	7.7
Earnings Per Share - S&P 500 ($)	4.01	4.01	4.46	4.07	4.38	4.31	16.72	16.42	17.50	18.50	19.81
Price-Earnings Ratio - S&P 500	11.5	11.7	10.4	11.6	10.8	11.2	9.5	11.2	11.0	11.2	11.2

Forecast Assumptions:

Fiscal policy: The current forecast includes estimated budget savings from the First Concurrent Resolution passed prior to the Congressional recess for August. Shearson Lehman analyses indicate that nondefense savings were overstated by $9.9 billion, $12.3 billion, and $21.4 billion in 1986-1988. A portion of this amount is due to the implausibility of the Congress' assumption that it will pass legislation cutting income support to farmers in the midst of the most dramatic downturn in agriculture since the Great Depression. The exaggeration of savings also includes double-counting and unenforceable savings. It is important to note that the baseline estimates for defense used in the budget resolution were much too high. Thus, much of the defense savings ($24.6 billion in 1986, $33.5 billion in 1987, $41.9 billion in 1988) represents outlays that were unlikely to occur, regardless of Congressional action. This overstatement of defense savings does not affect the final deficit estimates--the baseline should have been lowered and the savings from the baseline reduced by the same amounts. But it does seem that the fiscal restraint that is actually being applied by the budget resolution, while significant, is not so great as is claimed. The combined effects of lower nondefense savings and less optimistic interest rate and real GNP growth rate assumptions lead to the following Shearson Lehman estimates of the deficit: $202.3 billion for FY1986; $192.5 billion for FY1987; and $173.6 billion for FY1988. The comparable budget resolution figures are $171.9 billion, $154.7 billion, and $112.9 billion.

Monetary policy: Accommodative to slightly easier through much of the rest of this year, with growth in the economy sluggish, monetary growth decelerating, and subdued rates of inflation. The excessive growth in M1 is finessed by support by the Federal Reserve of the G-5 agreement. All of this makes clear the central bank's concern with sustaining the expansion.

Policy mix: A modest and gradual change takes place in the "loose fiscal-tight money" policy mix that has characterized the economy--not enough to fully resolve the deficit dilemma and the imbalances that exist in trade, manufacturing, and the financial markets, but sufficient to prevent any major upward pressure on interest rates. The reductions in spending embodied in the FY1986 budget and the somewhat more accommodative stance of the Federal Reserve constitute the third twist in the policy mix over the last four years and suggest a lower profile of interest rates, a weaker dollar, and a better equity market than otherwise would have been the case.

Oil prices: As measured by refiners' acquisition costs, oil prices are assumed to drop another $1 to $2 a barrel over the next six months. OPEC oil production rises with seasonal demands, and Saudi Arabia increases production to 4.3 million barrels per day. Saudi netback arrangements reduce spot crude oil prices to near $26.50 per barrel by late in the year.

Agricultural prices: Continuing weakness in most basic commodities and agricultural prices for the rest of this year, reflecting large supplies and the slack demands of weak economies throughout the world. Commodity prices begin to firm during 1986.

Wages and unit labor costs: In general, continuing downward pressure on wages from economic slack, the effects of deregulation, increased competition, and the decline in union strength. While contract negotiations should be slightly more favorable to labor this year and next, a tough stance by management is assumed to keep labor cost increases modest--about 3% per annum for this year and next.

Third World debt and bank problems: The debt problem is turning more critical. Mexico was out of compliance with its IMF program and in financial difficulty before earthquakes rocked Mexico City. At the United Nations, Latin American debtors blasted the IMF. Peru threatened to quit the Fund. With the IMF/World Bank annual meetings coming up, the debt crisis will become more visible. The bank-to-government via IMF dialogue may well be unravelling in favor of more government-to-government discussions. LDC debt and its fallout is a constraint to growth.

Growth in the rest-of-the-world economies: The economic expansion in developed countries is expected to be sustained through 1985 and 1986. European countries continue to grow at moderate rates of about 2% to 3-1/2%, with some improvement for inflation but little on the unemployment front. Growth rates in Canada and Japan will exhibit a slowdown in 1985 and 1986 as a result of a slowdown in U.S. economic growth, but will remain relatively high--at about 4% to 5%. Likewise, Far Eastern countries such as Taiwan, Singapore, Korea and Hong Kong, highly dependent on exports, will suffer as a result of declining U.S. imports in late 1985 and 1986. Latin American countries will also be affected by reduced U.S. imports but, excluding Mexico, will show a small but positive growth.

Alternative possibilities and probabilities: An alternative to the baseline (Higher Rates Scenario, probability = 15%) assumes above-target money growth and strong economic growth in the second half of the year. The higher monetary growth is associated with higher inflation and higher interest rates, which push the economy into a recession by the latter part of 1986. A second alternative (Fizzling Out Scenario, probability = 15%) assumes that the economy fades into recession this year, fizzling out from weak foreign trade, slack in consumer spending, and too long a delay in easing by the central bank. Once the recession occurs, monetary growth eases and the Fed aggressively loosens policy. Interest rates decline by one to two percentage points over the next year in this scenario. Finally, a third projection (Lower Inflation Scenario, probability = 5%) assumes a sharp decline in oil prices that leads to lower inflation, reductions of interest rates, and higher growth rates than in the baseline forecast.

Trade Legislation and Tax Reform: The G-5 agreement is assumed to result in coordinated periodic interventions against the dollar--mostly by Japan and West Germany--speeding up and intensifying the dollar decline that began in late February. A slight notch of easing late in the year by the U.S. central bank, after monetary growth eases, helps to keep the dollar down to levels near 2.5 deutschemarks, 210 to 215 yen, and 8 French francs--levels to which the dollar would have fallen anyway, but not until next year.

First, it is assumed that the budget tightening of the past summer results in slowed economic and monetary growth, thus permitting more leeway for the Federal Reserve to be accommodative or to ease somewhat to sustain growth. Second, the Federal Reserve is assumed to ease later this year, helping to reduce real interest rates and the dollar another notch. This assumption is open to question, however, given the rapid decline in the dollar and the potential for a dollar-induced reinflation. The central bank fears this eventuality. Third, no major protectionist legislation is assumed, a somewhat risky view unless the U.S. industrial sector improves greatly over the next year. Fourth, tax reform is assumed to be neutral in its impacts on macroeconomic growth. The risk is that as it currently stands, the tax increases for business could bring a major slowdown in the first year of passage. Fifth, the G-5 intervention is assumed to accelerate the decline of the dollar, since the dollar would have dropped anyway, helping to speed a turnaround in foreign trade. However, the risk here is that without underlying fundamental reforms in the monetary and fiscal policies of the United States and rest-of-the-world countries, no lasting benefit or improvement can occur for the U.S. industrial sector. Sixth, it is assumed that weakness in the goods sectors is not carried over into the services sectors, so services activities can keep carrying the economy. Seventh, oil prices are expected to decline further, offsetting the potential reinflationary effects from a weaker dollar.

These are a lot of "ifs," so much so that the risk of recession must be regarded as one-in-four. How would a recession arise? One way is through a fizzling out, a fading into a downturn as demands weaken and the competitive pressures on the tradable goods sector takes its toll. The other eventuality leading to a recession would be a dollar collapse, stronger growth than expected because of improving net exports, excessive monetary growth, accelerated inflation, higher interest rates, and restriction by the Federal Reserve.

With all these sources of risks to the expansion, there must be better ways to insure growth than through current economic policies.

Economic Policy and Sustaining Expansion

To sustain the expansion at a pace that is adequate for reducing unemployment requires further declines of interest rates and of the dollar.

The G-5 intervention can accelerate declines in the dollar and speed the improvement in foreign trade, but without charges in the underlying policies of the countries concerned, a lasting improvement will be difficult to achieve. Fundamentally, the U.S. budget deficit is still too high and monetary policy remains tighter than necessary, with real interest rates and the dollar too high to sustain the expansion at the 3% to 4% rate that would bring the unemployment rate down to a full employment zone.

There are several policy options available. First, and ideally, would be further reductions in the federal budget deficits. Such a tightening should be offset by a compensating ease in monetary policy. By a compensating ease is meant injections of bank reserves so as to raise monetary growth to the levels that would have existed before the budget tightening. The effects of such a policy twist would be lower nominal and real interest rates, a drop in the dollar, and higher equity prices. Little change in overall growth should be expected. But there would be a decided shift in the composition of economic activity, toward rising growth in the goods sectors and less activity in the services sectors. Although slow in coming, U.S. industry probably would begin to regain some of its lost market share.

At this point, much less remains to close the remaining deficit gap with some combination of increased economic growth and higher taxes the apparent means to reach a $100 billion federal budget deficit by fiscal year 1988. This solution would not only be good for the United States but also the rest of the world, where high interest rates and a strong dollar continue to create difficulties.

With the string having run out on reductions in spending as a means to reduce the federal budget deficits, higher taxes or increased growth are the only alternatives for further deficit gap closing. Full employment budget calculations provide estimates of the reductions yet necessary, estimated to be $117.4 billion by FY1988. Another possibility is a sufficient amount of deficit reductions to lower the unified budget deficit to approximately $100 billion in FY1988 or 2% of nominal GNP, the target originally set by the Congress and Administration. In the latter case, according to current budget deficit estimates by Shearson Lehman Economics, about $75 billion of deficit reduction by 1988 would be necessary.

How much of the deficits can be eliminated through increased economic growth? The federal budget deficits are most sensitive to economic growth, inflation, and interest rates.

An easier monetary policy by the Federal Reserve that reduced interest rates by one percentage point would reduce the budget deficit by $14 billion in FY1988. If, at the same time, one percentage point of additional real economic growth was induced, another $37 billion of deficit reduction would occur. If inflation were one-half percentage point higher and the unemployment rate 0.3% lower, then by FY1988 another $5.5 billion reduction in the deficit would be achieved. The total of $56.5 billion by FY1988 would reduce the estimated deficit to $117.1 billion, just $17.1 billion above the $100 billion or 2% of nominal GNP target. Only a very modest tax hike would be required to eliminate the $15 billion to $20 billion difference.

To completely remove the full employment budget deficit by FY1988 would require a considerably larger tax increase. For example, an oil import surcharge of $5 per barrel would be raised $10 billion to $15 billion of revenues. To remove the remainder of the full employment budget deficit would require something like the enactment of tax reform with higher individual and corporate tax rates than envisioned by the President. A preliminary estimate is that if rates were cut by something less than one-half that proposed by the President while all the other revenue-raising measures were enacted (including eliminating deductibility of state and local taxes), then the high employment deficit could be virtually wiped out. Clearly, such a drastic turnabout in policy is unlikely, but it is useful, nonetheless, to consider what steps would be needed to completely eliminate the structural budget deficit.

A second possibility is for the Federal Reserve to ease in order to defuse the current situation. Such action may be inevitable, but ultimately cannot work unless the budget deficit also is reduced. Loose fiscal and loose monetary policy can only produce higher inflation and higher interest rates in the long run. In such a case, the central bank would only be able to ease slightly.

A third possibility is intervention to drive the dollar down enough to eliminate the current account deficit. But a lower dollar will set up pressure for higher interest rates, thus is self limiting.

Clearly, most choices cannot necessarily produce a sustained expansion of a long time. Only a further redressing for the unbalanced policy mix offers the greatest assurance of sustaining the expansion.

Summary

Economic policy has had and is having a major impact on the performance of the U.S. and world economies. Economic policy was responsible for the superlative performance of the U.S. economy in 1983 and 1984 and the revival and growth of the rest of the world economies as well. But the very policies that created the strength are now responsible for most of the negatives that characterize the current economic scene.

Today's negatives, which include stagnant economic growth in the U.S., weakness in profits and incomes, still high real interest rates, a still strong dollar, intense foreign competition, and continuing loss of market shares to the rest-of-the-world on tradable goods, essentially a recession in goods-producing industries especially manufacturing, and inflationary threat of a declining dollar, the rising threat of protectionism, and monetary policy hamstrung because of a declining dollar and excessive monetary growth, stem from the loose fiscal-tight monetary policy of previous years. Such a policy mix in an open economy with flexible exchange rates must, unless reversed, ultimately produce stagflation and the slow demise of the industrial base.

Sooner or later, the policymakers will realize that the only solution for these difficulties lies in rebalancing an unbalanced set of monetary and fiscal policies in the United States and abroad. Twisting the U.S. policy mix to a tighter budget and easier monetary policy and reversing this twist abroad is what is necessary. A coordinated attempt to do so is preferable to a coordinated attempt to drive the dollar down through currency intervention. The problems of an unbalanced policy mix had become severe enough three times in the last four years so that a twist in the policy mix has been necessary: in 1982, 1984, and 1985. Rather than management by crisis, it is time to move toward a more permanent solution to these problems.

Recommendations:

1) The Administration should declare its intention to eliminate the structural budget deficits by 1990, raising taxes within the framework of the new tax reform proposals and requiring other countries to stimulate their economies. The shift in the policy mix of the U.S. and its trading partners should be accomplished gradually, but well planned over the next five years, and staged to prevent dislocations in financial markets.

2) At the same time, the U.S. central bank should declare its intention to contribute to deficit reduction by engineering lower interest rates and higher economic growth than recently. By doing this, the path to deficit reduction will eventually end up including spending reductions, accomplished in 1985 by the Congress; tax increases; an increase of economic growth, the combination necessary to balance the full employment budget and reduce unified budget deficits to 2% or less of nominal GNP by FY1988.

3) The Finance Ministers and the Treasuries of G-5 countries should agree that intervention will be maintain orderly movements in currencies as shifts in the policy mix are achieved.

4) Selective legislation designed to "protect" those industries in the United States that suffer "unfair" trading partner practices from abroad.

5) The President's tax reform proposals, modified such that revenues are raised as part of a package to eliminate deficits, should be enacted, accomplishing an one-fell swoop marginal tax rate reductions, base broadening, and revenue enhancement to help eliminate the excess budget deficits.

What would be the impacts of this coordinated policy attack on the current problems? Most likely, a new lower profile of interest rates would be established, the dollar weaken, equity prices improve, and the composition of output shift toward a rebalancing of the unbalanced growth in goods and services activities. The lower interest rates would contribute to a easing of the problems of the LDC countries. The weaker dollar would improve the prospects for countries who must pay debts in dollars. And, sufficient economic growth could be achieved to bring the unemployment rate lower.

One way or another, the policymakers will have to reach a solution similar to what is being suggested, whether piecemeal or well-planned. An aggressive, coordinated attack on the growing problems of the U.S. and world economies are better dealt with now, rather than reacting with other policy solutions which might fail to sustain worldwide expansion.

Chairman LAFALCE. Thank you very much, Mr. Sinai.

We will now hear from Mr. Levy, of Levy Economic Forecasts.

STATEMENT OF S. JAY LEVY, CHIEF ECONOMIST, LEVY ECONOMIC FORECASTS

Mr. LEVY. Thank you, Mr. Chairman.

I am pleased to be here and to be able to acquaint the committee with the outlook for the economy as seen by Levy Economic Forecasts. We are always mindful that we are dealing with probabilities and that critical developments which cannot be foreseen or anticipated from experience sometimes greatly influence the future course of the economy.

In that spirit, I will discuss the probability of each of three developments: recession, continued sluggishness, and renewed vigor.

An unsatisfactory economy is highly probable in the remaining months of 1985 and 1986. A recession beginning before the end of 1985 is the most likely development. Should a recession not begin within the next few months, the economy will probably be moving ahead at an unsatisfactory pace, one that will see unemployment above 7 percent, poorer profits for business, decreasing private capital expenditures, and exacerbation of the financial problems that are already troublesome and worrisome.

The economy has a small chance of gaining upward momentum; that progress would span only a short period and it would lead to more serious difficulties when, later on, the economy fell into recession.

Before delving into the reasons for our appraisal of the future, I would like to give you an idea of how we forecast, since our approach is different than those used by all other economists as far as I can determine. To do this is important. While I was listening to Allen Sinai, it struck me that he and I look upon events in the economy in quite the same way, but when we put them into our framework we reach different conclusions about where the economy is going.

Our primary focus is on profits rather than on an aggregate of income or product or on monetary phenomena that are related to income and output. After we have our forecast of profits, we use it to help estimate future trends of gross national product, total income, and other phenomena.

One would expect profits, in a profit-motivated system, to be a leading indicator. They are generally regarded as such.

We begin with the premise that ours is a profit-motivated system. When business finds that its profits are equal to or in excess of expectations, it expands in the hope that it will be rewarded with even larger profits. It increases its investments in plant, equipment, production, and employment. Ten billion dollars of profits may stimulate wage and salary payments of $50 billion.

But, sometimes, business finds that its profits are less than anticipated. Such a circumstance almost always means: "We did not sell all of the goods that we expected to sell at the prices we expected to receive. We are stuck with unwanted inventories. We will have to cut production and, in the process, lay off workers until inventories are in line with sales." This situation is, of course, a recession.

The familiar economic truism, "saving equals investment," which is one of the tables in the national income and product accounts, becomes the heart of our analysis. We transpose the terms in the savings-investment equation so that we have an equation that expresses aggregate profits in terms of the various types of investment and saving.

Investments in business structures and equipment, in inventories, and in residential dwellings are flows of funds that add to aggregate profits—"sources of profits." A favorable balance of trade is a source of profits. So is the net flow of funds into the private economy from Government; that is the Government deficit. Personal saving, the diversion of funds from consumption, reduces profits--personal saving is a negative source of profits. I will discuss the economy's present position in terms of the activities affecting profits and then indicate how these activities are likely to affect the trends of profits and of the broad economy in the periods ahead.

Profits and, therefore, the economy in general received a strong stimulus so far in 1985 by the reduction in saving, by the decline in the personal saving rate from 6.1 percent for all of 1984 to 4.8 percent in the first half of this year, about 3.5 percent in the past few months, and 2.8 percent in August according to the preliminary estimate. Personal saving, almost dollar-for-dollar, reduces total profits. Usually, saving varies much less than the other phenomena that determine aggregate profits. But in late 1985, its changes have become so large that savings are now the dominant influence on the direction of the general business trend.

The more than 2-percentage-point drop in the saving rate between the end of 1984 and the third quarter of 1985 meant that pretax profits were about $50 billion larger in the third quarter than if saving had remained at the 1984 rate. If profits were $50 billion smaller in the third quarter than they actually were, you can be sure that the United States would have been deep in a serious recession.

Rising capital investment is usually the healthy source of profits that is the sine qua non for an authentic, sustained period of prosperity. Business fixed investment played a major role in increasing profits during the strong recovery of 1983 and the first half of 1984. This rise in capital investment slowed toward the end of last year and the trend is now turning downward.

Business investments in inventory during the first three quarters of 1984 attained an average annual rate of $65 billion. In the second quarter of 1985 this investment was running at an $18 billion yearly pace. It was slower in the third quarter. This drop of over $47 billion is the near demise of a strong stimulus to business activity, of a major flow of profits.

Investment in housing has been helped by declining mortgage rates, but it was also helped by the lax standards of lenders in determining which borrowers could afford to meet their financial obligations. As a result the number of foreclosures increased disturbingly and lenders are now being more careful. The favorable effect of lower interest rates is being somewhat offset. Moreover, and in the long run more important, the adult population is growing at a decreasing rate.

Whereas in the latter 1970's, the number of persons 18 years old and older was increasing at the rate of 3 million a year, the increase is now about 2 million, and in the early 1990's it will be down to 1.5 million. Giving considerable weight to the influence of lower interest rates, we expect no decline in residential construction until and unless we are clearly in a recession.

A positive balance of trade, a net inflow of funds from abroad, is a "source of profits." The trade deficit of 1985, so far at an annual rate of about $140 billion, is a huge drain of profits from domestic business. This drain has been offset by the Federal deficit. Government borrowing is a source of profits.

The public sector deficit, the red ink of the U.S. Treasury plus the sizeable surplus of the State and local governments—in the national income accounts—has about equaled the trade deficit. As long as the trade deficit is vast, the economy demands an offsetting Treasury deficit.

The future course of the economy depends mainly on four highly volatile phenomena—personal saving, the balance of trade, the Federal deficit, and change in inventory. In the past, change in inventory was the only widely moving performer. But now all of them, because of their unprecedented magnitudes or for other reasons can and often do vary by $20 billion or more, annual rate, from quarter to quarter.

Saving by itself may well determine the economy's next move. The chances are that saving will rise in the near future. If the saving rate reaches 5 percent, the Nation will be in a recession. Real gross national product will be declining. If the rate of saving increased to about 4.5 percent, the economy will be drifting sluggishly toward recession. GNP will be increasing at about 2 percent annual rate.

In the unlikely but, indeed, possible event that saving remains at 3.5 percent or at 2.8 percent where it was reported to be in August—in other words, if the rate of consumption stays extraordinarily high—business conditions will improve. GNP will advance at a pace of at least 4 percent annually.

Capital investment, which is the foundation of sound, sustained periods of expansion, will even under the best circumstances be held down by recent, extensive overbuilding. At present the trend is turning downward. Even if the economy improves considerably as a result of low saving, it will have little need for more office buildings, hotel rooms, and shopping centers. Overbuilding and, indeed, speculation have provided the Nation with more commercial space than it can absorb for some time to come.

When excess space was built in the middle 1970's, the mistake was soon offset by the rapid growth of the adult population. In the mideighties, demographics will be much slower in rescuing the economy. By the early 1990's, because of the slow growth of the adult population, a good year for housing will be one with only 1 million starts.

Inventories, it has frequently been asserted, are extremely low. How low inventories are in any period is not only a matter of their physical size relative to unit sales. During periods of inflation, the incentive is great to anticipate future needs. When real interest rates are high, so is the pressure to keep stocks as small as feasible. At present, inflation in the price of goods is practically nil, and interest rates are high. Moreover, deliveries are prompt and shortages virtually unknown.

If the economy remains sluggish, inventories will tend to be accumulated at a rate close to zero. Stocks will plunge during a recession. They will rise if the economy as a result of a continuing consumption spree expands, but the rise is unlikely to be large.

The economy will be aided by the favorable turn in the trend of the balance of trade that will come as a result of the declining dollar. The probable further, significant decline in the dollar will reduce the trade deficit and increase profits. The combination of a saving rate near 3.5 percent and a sizable narrowing of the trade deficit would greatly improve business conditions.

The Treasury deficit's widening when the economy drops into a recession, narrowing as it begins to expand will tend to keep the economy in a state of sluggishness. But budget trimming that becomes effective as the economy totters on the brink, could push it over the edge, into recession. The next recession will hit an economy that is debilitated in significant ways.

Many financial and some of industrial pillars of our economy are in bad shape. They will prevent a period of genuine prosperity from developing; they mean that we will remain in the midst of economic turbulence for a number of years. Certainly they threaten economic stability.

The overbuilding already mentioned and the mountains of poor quality debt are facts of economic life that will not go away. Problems of Third World debtor nations are not going to be solved for years if at all. No quick solution to the farmers' difficulties is at hand. Two trillion dollars of personal debt is symptomatic of wealth moving about through financial maneuvers rather than of wealth being created.

The change in the position of the United States from the predominant industrial nation, which it was 15 or 20 years ago—to a competitor among equals (in capabilities if not size—is a fact not subject to change by a fall in the dollar.

The likelihood is that we have no escape from painful adjustments as a result of past excesses—speculation in everything from shopping malls to farmland—speculation that the values of homes will be continuously propelled upward by inflation—even speculation that the Federal budget will be balanced before the rising interest payments lead to a fiscal crisis.

We are not living in a period that resembles any other experienced since World War II. Fiscal and monetary policy are therefore thwarted by circumstances from being major aids to the economy at this time.

Should the saving rate move back to 5.5 percent or higher in the coming months, the concurrent economies of Federal spending will contribute to the seriousness of the recession. Moreover, the unfavorable implications of the huge Federal deficit greatly diminish the possibility of utilizing fiscal policy as a tool for economic stabilization.

For a variety of reasons ranging from the aftermath of virulent inflation to the deregulation of financial institutions, monetary policy is almost impotent as a tool for economic stabilization. If a decline of interest rates were to result in more commercial and residential construction, the unneeded space would, in a short time, cause a more acute plunge in capital expenditures than would have occurred without such a stimulus to investment.

Certainly the health of the economy will not be promoted for long by the greater use of credit by consumers. On the other hand, higher interest rates would reverse the downward trend of the dollar and discourage investments where they are needed—certainly American industry in this competitive world should be able to finance the purchase of all the electronic, robotic, and other devices it requires to reduce costs and produce new and better products.

[The prepared statement of Mr. Levy follows:]

Statement by

S Jay Levy

Chief Economist, Levy Economic Forecasts

before the

Subcommittee on Economic Stabilization

United States House of Representatives

October 2, 1985

I am pleased to be able to acquaint this Committee with the outlook for the economy as viewed by Levy Economic Forecasts. We employ a unique approach in the process of reaching our conclusions--we rely on a macro-economic analysis of aggregate corporate profits. We are always mindful that we are dealing with probabilities, and that critical developments which cannot be foreseen nor anticipated from experience will sometimes greatly influence the future course of the economy. In that spirit I will discuss the probability of each of three developments: recession, continued sluggishness, and renewed vigor. Should the third possibility occur and economic growth accelerate, the improvement would be short-lived.

An unsatisfactory economy is highly probable in the remaining months of 1985 and in 1986. A recession beginning before the end of 1985 is the most likely development. Should a recession not begin within the next few months, the economy will probably be moving ahead at an unsatisfactory pace, one that will see unemployment above 7%, poorer profits for business, decreasing private capital expenditures, and exacerbation of the financial problems that are already troublesome and worrisome. The economy has a small chance of gaining upward momentum; that progress would span only a short period and it would lead to more serious difficulties when, later on, the economy fell into recession.

Before delving into the reasons for our appraisal of the future, I would like to give you an idea of how we forecast, since our approach is different than those used by all other economists as far as I can determine. Our primary focus is on profits rather than on an aggregate of income or product or on monetary phenomena that are related to income and output. After we have our forecast of profits, we use it to help estimate future trends of gross national product, total income, and other phenomena.

One would expect profits, in a profit-motivated system, to be a leading indicator. They are generally regarded as such.

We begin with the premise that ours is a profit motivated system. When business finds that its profits are equal to or in excess of expectations, it expands in the hope that it will be rewarded with even larger profits. It increases its investments in plant, equipment, production, and employment. Ten billion dollars of profits may stimulate wage and salary payments of $50 billion.

But sometimes, business finds that its profits are less than anticipated. Such a circumstance almost always means: "We did not sell all of the goods that we expected to sell at the prices we expected to receive. We are stuck with unwanted inventories. We will have to cut production and, in the process, lay off workers until inventories are in line with sales." This situation is, of course, a recession.

The familiar economic truism, "saving = investment," which is one of the tables in the national income and product accounts, becomes the heart of our analysis. We transpose the terms in the savings-investment equation so that we have an equation that expresses aggregate profits in terms of the various types of investment and saving.

Investments in business structures and equipment, in inventories, and in residential dwellings are flows of funds that add to aggregate profits--"sources of profits." A favorable balance of trade is a source of profits. So is the net flow of funds into the private economy from government, that is the government deficit. Personal saving, the diversion of funds from consumption, reduces profits--personal saving is a negative source of profits. I will discuss the economy's present position in terms of the activities affecting profits and then indicate how these activities are likely to affect the trends of profits and of the broad economy in the periods ahead.

Profits and therefore the economy in general received a strong stimulus so far in 1985 by the reduction in saving, by the decline in the personal saving rate from 6.1% for all of 1984 to 4.8% in the first half of this year, about 3.5% in the past few months, and 2.8% in August according to the preliminary estimate. Personal saving, almost dollar-for-dollar, reduces profits. Usually, saving varies much less than the other phenomena that determine aggregate profits. But in 1985 its changes have become so large that they are now the dominant influence on the direction of the general business trend.

The more than 2 percentage point drop in the saving rate between the end of 1984 and the third quarter of 1985 meant that pre-tax profits were about $50 billion larger in the third quarter than if saving had remained at the 1984 rate. If profits were $50 billion smaller in the third quarter than they actually were, you can be sure that the U.S. would have been deep in a serious recession.

Rising capital investment~~s~~ is usually the healthy source of profits that is the *sine qua non* for an authentic, sustained period of prosperity. Business fixed investment played a major role in increasing profits during the strong recovery of 1983 and the first half of 1984. This rise in capital investment slowed toward the end of last year and the trend is now turning downward.

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A positive balance of trade, a net inflow of funds from abroad, is a "source of profits." The trade deficit of 1985, so far at an annual rate of about $140 billion, is a huge drain of profits from domestic business. This drain has been offset by the federal deficit. Government borrowing is a source of profits, and government saving, like personal saving, is a drain on profits.

The public sector deficit, the red ink of the U.S. Treasury plus the sizable surplus of the state and local governments (national income accounts), has about equaled the trade deficit. As long as the trade deficit is vast, the economy demands an offsetting Treasury deficit.

The future course of the econonomy depends mainly on four highly volatile phenomena--personal saving, the balance of trade, the federal deficit, and change in inventory. In the past, change in inventory was the only widely moving performer. But now all of them, because of their unprecedented magnitudes or for other reasons can and often do vary by $20 billion or more, annual rate, from quarter to quarter.

Saving by itself may determine the economy's next move. The chances are that saving will rise in the near future. If the saving rate reaches 5%, the nation will be in a recession. Real gross national product will be declining. If the rate of saving increases to about 4½%, the economy will be drifting sluggishly toward recession. GNP will be increasing at about 2% annual rate. In the unlikely but, indeed, possible event that saving remains at 3½% or at 2.8% where it was reported to be in August (in other words, if the rate of consumption stays extraordinarily high), business conditions will improve. GNP will advance at a pace of at least 4% annually.

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The economy will be aided by the favorable turn in the trend of the balance of trade that will come as a result of the declining dollar. The probable further, significant decline in the dollar will reduce the trade deficit and increase profits. The combination of a saving rate near 3½% and a sizable narrowing of the trade deficit would greatly improve business conditions.

The Treasury deficit's widening when the economy drops into a recession, narrowing as it begins to expand will tend to keep the economy in a state of sluggishness. But budget trimming that becomes effective as the economy totters on the brink, could push it over the edge, into recession.

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For a variety of reasons ranging from the aftermath of virulent inflation to the deregulation of financial institutions, monetary policy is almost impotent as a tool for economic stabilization. If a decline of interest rates were to result in more commercial and residential construction, the unneeded space would, in a short time, cause a more acute plunge in capital expenditures than would have occurred without such a stimulus to investment. Certainly the health of the economy will not be promoted for long by the greater use of credit by consumers. On the other hand higher interest rates would reverse the downward trend of the dollar and discourage investments where they are needed--certainly American industry in this competitive world should be able to finance the purchase of all the electronic, robotic, and other devices it requires to reduce costs and produce new and better products.

Chairman LaFalce. Thank you very much. I will refrain from asking questions until the other Members of the panel have had an opportunity.

First, we call upon Congresswoman Kaptur.

Ms. Kaptur. Thank you, Mr. Chairman.

I was interested in all of the witnesses' testimony. I really appreciate this hearing this morning. In looking at several of the indicators, each of you talked about looking toward the future. I wanted each of you to address two areas a little more specifically and this will be the only question I have.

The first concerns savings and the role of savings in the economy. In spite of what Mr. Levy has said, I have been urging my audiences back home in Ohio to save more, saying that we have lost the ability to save as a society. That is reflected both in the Government deficit as well as in the rising level of consumer debt, about which I am very concerned. In addition to that, the rising level of corporate borrowing, some of it from foreign sources now, further indicates inadequate domestic saving. Therefore, I have been telling my audiences they ought to really think about the American people again developing a habit of savings.

According to Mr. Levy, that is probably the wrong advice but I would like each of you to comment on that.

Second, could anyone give me a concise view of what has really been happening with the accessing of foreign credit by the U.S. economy, both Government borrowing and purchases of corporate securities by foreign interests as well as foreign investment in the United States. What has been happening over a period of time and what implications do you see that that might have for the future.

I would like a little more discussion in those two areas, one on savings, the other on foreign inflows of money into this country.

Chairman LaFalce. Let's take savings first. Mr. Levy, why don't we start with you since Ms. Kaptur has called into question your position on savings.

Mr. Levy. I think you are giving your constituents the right advice.

Ms. Kaptur. You do?

Mr. Levy. I think people should save and the economy should provide an incentive or at least an opportunity to save.

Ms. Kaptur. What is the best incentive we have for savings?

Mr. Levy. Well, maybe I am a little old-fashioned but I remember when people used to talk about saving for a rainy day, and that seemed to be a very good incentive. Certainly a lot of our savings are institutionalized in Government and private pension funds of one sort or another, so a great deal of saving for old age or other contingency is automatically done that way.

I think we do have to recognize that a great deal of saving is institutional. But I think that an abnormal decline in savings is something that will be paid for a little later by the economy, as far as the economy is concerned. We did benefit, I feel strongly, in 1985 from the fact that we had a low savings rate, but this has a very little possibility of being kept up and so——

Ms. Kaptur. Because the level of personal debt increased, the savings rate went down, way down to fund the automobile purchases that you talked about?

Mr. LEVY. Not only does that increase but, for example, the payments of interest by consumers has been rising at a phenomenal rate, easily at a record high, allowing for growth and everything else.

But as consumers incur more and more of this obligation, less and less will be spent in stores. As a result the economy turns down, they are stuck with the debt obligations, and they can be of less help in helping a revival of the economy.

For some very strange reason, which I think has to be viewed as an aberration unless in the future we find something else has happened, the savings rate got to be very, very low in 1985.

As far as—I don't know if I have answered your question, that aspect of your question?

The other aspect of your question, it seems to me, is really three questions. One seems to——

Chairman LAFALCE. I don't think it did really answer her question, for my purposes in any event. I take it Ms. Kaptur's question goes to the point of your statement—that if the savings rate were to go up, at least if it were to go up precipitously, that it might be recessionary. You did say that.

Mr. LEVY. Yes, so I——

Chairman LAFALCE. Would you reconcile that statement, if you will, with your answer to her that she is giving good advice to her constituents. Is it the volatility of the savings rate, precipitous nature of savings, or what?

Mr. LEVY. First of all, when I talk to individuals if the question comes up I will encourage them to save—if that makes any sense—but we have had the good or maybe in the long run it will be viewed as the poor fortune to have had an abnormal decline in the savings rate and it is such a departure from anything we have seen in the past, including 1984—I don't know if I should use the term "normal"—but one has to assume that there is an enormous probability that the savings rate is going to go back to what is some concept of normalcy.

We have been complaining for years that 7 percent is much lower than other countries, and in the long run it is not good for the economy.

Ms. KAPTUR. That is right.

Mr. LEVY. When it gets down to 3 percent or less, as it did in August, unless we change our premise we cannot believe that is really in the long run good for the economy, even though it gave the economy a shot in the arm temporarily.

Chairman LAFALCE. It seemed to me you were challenging the premise when you said that if it does go back up, it will be recessionary because we wouldn't have the money being spent on consumer goods. Am I correct in saying that that is what you said?

Mr. LEVY. I would say that other things——

Chairman LAFALCE. Did you not say that?

Mr. LEVY. I said something similar to that, OK.

Chairman LAFALCE. All right.

Mr. LEVY. I have to elaborate on that point.

Really what has hurt the economy more than anything else is the balance of trade deficit. The abnormality of the savings rate rescued us from the problems that that balance of trade deficit would otherwise have imposed. I don't think we can tackle our problem from the angle of having an abnormally low savings rate as a policy, when really the balance of trade deficit is the underlying cause of the weaknesses in the economy and of a recession. If one occurs—I think it is probable in the near future.

Chairman LaFalce. Before we go on, would Mr. Sinai or Mr. Evans care to respond with their perspective on the savings rate.

Mr. Sinai. It is really a puzzle. The real after-tax returns on savings are high and the real after-tax costs of borrowing are also very high, so it is a puzzle. And, on these data, which by the way often get revised when the Commerce Department does its 3-year revisions, the savings rate, which looks so low, may not turn out to be so low after they do the revision.

We all try——

Chairman LaFalce. You mean 3 years later?

Mr. Sinai. At the end of the year.

Chairman LaFalce. You said a 3-year revision.

Mr. Sinai. They have a big one every 3 years, and they have that one this December, I think.

Mr. Evans. Yes, this December.

Mr. Sinai. So we figure something out and suddenly, the data change and we have to figure the new story based on that. The saving rate is a legitimate puzzle and may have something to do with the various new plans in which moneys are put away for retirement, and it may be that in the life cycle framework of spending and savings, consumers may see a pot at the end toward retirement age that gives less incentive to save at the current time.

If we have a jump in the savings rate in the next quarter, which seems to me we will have, that corresponds to a decline in consumption, it is just arithmetic and the drop in consumption are two sides of the same coin.

To save more means there will be less spending out of a given income. That is where the recessionary threat is in the next quarter or two if we were to go to a 3.5- or 4-percent saving rate.

Ms. Kaptur. Are pension fund accruals not picked up in your chart savings 3?

Mr. Evans. It is not in the money supply. It is still in savings.

Mr. Levy. In private pension funds, but not in Government pension funds. If you throw in the Government pension funds the savings rates over the long-term looks a little higher.

Mr. Price. Still dropped.

Mr. Sinai. We save less than under, it is a legitimate puzzle. Maybe it is 3 or 4 percent, how you measure it and what gets counted may be argumentative. I think a cut in spending by households in the fourth quarter with a reversal of auto sales will slow the economy down when they save in that period.

That is a different question. Different from the issue of whether you ought to tell people to save.

I think I have the same feeling, it would be better to save more now given the incentives which consumers seem to be ignoring, but it is better to save more and it has to do with the timing question when it happens. Less saving now corresponds to more spending and more taking on of debt.

The debt taken on generates an interest payment stream for a long time on that debt. What you see in the data is not only very high debt relative to income for almost all kinds of debt for households, you see rising debt service charges as a portion of income, current income. It is a bigger claim against current cash flow for households.

Ultimately special——

Ms. KAPTUR. When I give a speech, I tell my audiences to save.

Mr. SINAI. There is a table that has the data on that in my testimony.

Ms. KAPTUR. With debt, people are paying more interest and longer on principal.

Mr. SINAI. Table 3 actually provides the data.

Ms. KAPTUR. I am looking at this. If you want to give a picture to the American public on the rate of borrowing and the payment of interest or even payments, where do we look?

Mr. SINAI. Table 3 shows different dimensions. Total debt outstanding for households, whether installment or personal loans or total consumer credit, and all home mortgage credit as a ratio of income is at post-war highs. Debt-to-income ratios are at post-war highs. They do total something like $2 trillion.

This is——

Ms. KAPTUR. Where is the ratio?

Mr. SINAI. That is as a percent of disposable income.

Ms. KAPTUR. 78.2 percent.

Mr. SINAI. That is the total, total debt outstanding. That is a percent of total debt outstanding.

Ms. KAPTUR. Explain what that debt means?

Mr. SINAI. The sum of consumer credit, total debt outstanding, installment and personal loan debt and home mortgage debt, all of that together totals $2.1 trillion, and that is 78.2 percent of disposable income at the current time.

Ms. KAPTUR. OK.

Mr. SINAI. It is at a record high for post-war times. Consumers have taken on a lot of debt. The rate of change which shows——

Chairman LAFALCE. Where would you go to chart that out since World War II?

Mr. SINAI. Well, I guess the data go back to 1960. You would just see a steady upward trend with cycles around expansions and recessions. For example, you would see that accelerating very sharply, I think, in the year or two prior to a recession. Of course, that tells you, you can go on taking debt on for a long time before it comes home to roost and you suffer the consequences.

Ms. KAPTUR. Given the increase from 1960 to now, were you talking about factoring the interest payments into the ratio?

Mr. SINAI. That is another factor. That is one factor which I don't think most people, they don't look at the balance sheet relative to income. They certainly have interest payments on the debt as a fraction of current income. Those are very high.

Debt service, for example, interest payments on installment credit as a percent of disposable income is 3.4 percent; mortgages, 7.2 percent.

Ten and a half cents on a dollar of disposable income, a record high, now goes to pay interest on outstanding debt.

Ms. KAPTUR. Wouldn't the owners of credit card companies say that it is a great sign that the American public has faith in the future, because they are willing to borrow from the future to pay for the present purchases. That is a good thing.

Mr. SINAI. Interesting question, but the president of American Express, Mr. Gerstner, is actually very alarmed at these numbers and the reason he is, is really what Mr. Levy is getting at, and why I tell you that it is better to tell your people to save now.

You are telling them the right thing, not to borrow so much. The reason is that without realizing it, they are setting up a stream of interest payments which will be a claim on their cash flow on their income for a long time, and if they should run into a problem with a job or illness, they are going to have trouble making those payments; or if the economy should for some reason tip into a downturn, and with it prices come down, the real burden, value of that debt and the real value of those payments becomes very onerous and intensifies the downturn in the economy as the households realize they are in a crunch situation, cannot spend more and they cut back.

That has been part and parcel of the economy since the post-war period. By having the low rate of savings that we have had so far, it helps in the short run, keeps the economy going. But it is a very big long-run threat in terms of the sustainability of our expansion because like with our own deficits, the Federal Government deficits, the chickens come home to roost.

What I describe for the households, you can generically describe for the corporate sector, and apply it to LDC's who have big interest payments.

Chairman LAFALCE. Do you have a table with respect to the corporate sector and LDC's?

Mr. SINAI. That is back at the office. We track it for all dimensions of debt.

Chairman LAFALCE. Could you forward that to us?

Mr. SINAI. Sure. Frankly it is frightening if you think about what all of this accumulation of debt might mean.

Ms. KAPTUR. I think it is too. That is why I ask.

Chairman LAFALCE. Would you please accumulate it in a way that you have all the forms of debt.

Mr. SINAI. We have it, but we have not written the studies. I will try to get data on that.

Chairman LAFALCE. Look at the delinquency rate on mortgages.

Ms. KAPTUR. I was looking at that, yes.

Chairman LAFALCE. From one-half percent to 1 percent in 1980, to almost 6.5 percent now.

Ms. KAPTUR. We know the savings and loans are in trouble. We are sitting in the other subcommittee now worrying about the insurance funds for the savings and loans.

Mr. SINAI. Part of it is higher prices and part of it is that the accumulation of debt has been made easy by certain devices like ARM's, and extending the term on auto loans. That makes it easier.

The one reason why I believe consumers continue to borrow and spend, shows up in the monthly repayment data in this table. Mortgage repayments, dollars per month, you notice for a typical loan, is running 30 percent of median family income. That is not near the peak of 1980 where it was 33.3 percent. Auto loan repayments, dollars per month as a percent of median family income is also not at its—that 1970 number may be a typo—but it is not at its previous peak.

So I think what is happening to consumers is they look at how much they pay each month in their payments, they don't look at the debt-to-income ratios—economists look at that, consumers don't.

Can I do this this month or not, that is the question. If they can, they keep borrowing and spending. They are myopic, they don't realize they are getting into a lot of trouble.

Ms. KAPTUR. If you asked the question that John did, and went back to the Second World War and post-Second World War period, would the ratio have been below 50 percent?

Mr. SINAI. Yes, that represents also a different structural situation with regard to attitudes toward taking on debt. It is true today that saving for retirement is done for households in a number of ways. That was not true post-World War II.

We didn't have IRA, the Social Security system was not as well entrenched. We didn't have widespread pension programs in the companies where people worked. All kinds of reasons why we have institutionalized so much of the savings for households that incentives individually to save are less.

I do not know, I guess all of that shows up in the savings rate anyway, right.

Mr. EVANS. Supposed to, yes.

Mr. SINAI. That doesn't explain why we see 2.8-percent savings rate.

Chairman LAFALCE. We haven't given you a chance to weigh in on this. We meant to.

Mr. EVANS. Well, it is a perfect example of the old cliche, "three economists, four opinions" here. I think savings is good, I simply don't agree with the premise suggested that the higher savings rate will cause a recession.

In fact, I think a higher savings rate would help prolong the boom and for exactly the following reason. In my testimony earlier, I suggested that we sort of have been getting by with a sleight of hand by having foreigners pick up the bill, so to speak, and now I am convinced with the devaluation of the dollar this is going to stop, at least part of it will stop. So the real question is where are we going to find the funds?

My answer is that there are several domestic sources, but certainly an increase in personal savings would be one of them. In other words, if we don't have an increase in savings, personal or business or government savings, if we don't have one of them, we will have higher interest rates next year.

Chairman LAFALCE. I don't think you answered the problem posed, though. We have a problem in financing the huge trade deficit. We have financed that over the past several years with foreign borrowings.

Mr. EVANS. That is right.

Chairman LAFALCE. Are you suggesting foreign borrowings will go down, and it will be necessary to substitute with higher savings in that area? Won't the higher savings also mean reduced consumer spending? You have not addressed yourself to that.

Mr. Evans. No, because we will have a switch in the mix of GNP. We are going to have an improvement in that net exports. What I am saying——

Chairman LaFalce. That is highly problematic. Even if you do have a greater reduction in the value of the dollar, you might be talking about reducing the trade deficit from $150 billion to $120 billion or so.

Mr. Evans. But take that $30 billion. Set up a hypothesis where consumers just spend less on imports. Spend the same on domestic but save the rest. What is wrong with that?

Chairman LaFalce. They will have to spend more on the domestic goods; they will not be able to buy them at the same price. You are not comparing apples and apples.

Mr. Evans. I don't know if we will have increases in domestic prices because the dollar has diminished 20 percent in the last 6 months, and domestic prices have hardly gone up at all. It remains to be seen whether prices will be higher or not next year, because of the decline in the dollar.

But in general, what I am suggesting is that people take their savings and, take their money and save more of it domestically as an offset. If we have a slightly lower growth in consumer spending and a slightly larger improvement in net exports, then to answer your question, Mr. Chairman, we come out even on the GNP numbers.

The only time that an increase in savings hurts the economy is if there is no offset. If consumers save more but that is it, and nothing else happens, then that is bad for the economy. However, what usually happens is interest rates go down. There are more funds available.

Ms. Kaptur. That is right.

Mr. Evans. If interest rates go down, everybody benefits.

Ms. Kaptur. And even if the funds were borrowed, it would be money we owed to ourselves, it would not be money where we owed a foreign source of credit. That was the other question I wanted to get into, Mr. Chairman, and that is to what extent—how much do we owe to others now? You see these figures that 33 percent of the U.S. Federal securities purchases now are by foreign interests. I don't have the monthly figures or quarterly figures, but it is really hard to get a sense of the whole.

I have not seen an article that really puts it in perspective for me, who do we owe, how much, and over what period of time? I see this fact that troubles me as much as the budget deficit, because it is something we are going to have to do something about.

It is harder to estimate the impact of foreign investment in the United States, such as a Japanese company purchasing agricultural land in Ohio or German companies owning the two largest poultry farms in Ohio. We just see what is happening in the State that I come from.

Who measures that? Who has a sort of an accumulated understanding of what is going on there? I have not seen any article.

Chairman LaFalce. Complete?

Mr. Evans. Complete? The easy answer is no one.

Ms. KAPTUR. I saw a July or August report from the Commerce Department that talks about international investment, but it is over such a short time period that it doesn't set it in a context so you don't understand how much money we really owe, where, and over what time to others, first on Federal deficit and then looking at what is happening in the foreign investment in the United States as well as private corporate borrowing from foreign sources, both for overseas subsidiaries as well as companies here.

It is a hard thing to get a fix on that. Where would you go to understand the international capital flows?

Mr. EVANS. The numbers are in the current Fed figures in Business Week in the August issue, there are numbers that go back; they didn't bother to publish them. That is the most complete set of numbers we have on the subject. But the big news in the last few months has been we have become a debtor nation, which has been headline news.

Ms. KAPTUR. Right.

Mr. EVANS. On balance, of course, it is a very simple concept, we simply owe more to foreign parties than they owe to us. They have invested more in this country. The long-term implications are as you mentioned with the Japanese and Germans buying up domestic companies or properties and so forth, but the purchase of the Government debt by foreigners has been only really the tip of the iceberg. That is not where most of the foreign money has gone.

Foreign investment into this country is now running in the area of $120 billion a year. It will decline in the future quarters, but it has been up there for the last four quarters. Most of that has gone into the private sector.

The foreigners are not overly enamored of buying government debt. They don't see that as a great profitmaking opportunity. But what they want to do is buy real estate or buy companies in this country, because they see this as a long-term investment, they believe that the United States economy will do well relative to Europe or to other parts of the world.

In some cases, there are companies that want to get their money out and for political reasons want to put it here.

Chairman LAFALCE. We had hearings on this issue, and I don't have the facts at my fingertips so I cannot confront you with the facts. However, my recollection is that that investment has not been so much in private sector investments you were talking about, real estate, private companies, et cetera. A tremendous amount has been very liquid investments.

Mr. EVANS. A lot of it in private sector investments, a lot of it has been liquid, yes. But the figures of the Federal Reserve Board, and I cannot quote them verbatim, but only about 10 to 15 percent of the $120 billion went into U.S. Federal Government securities.

Ms. KAPTUR. That is the first time I have heard that. It was my impression that it was much larger in the Government side than in the private side.

Mr. EVANS. About half of it, say $60 billion went into—I guess what we call liquid assets, which could have been private sector, State and local governments. So they are mainly private sector.

The other $40 billion went into what we call long-term assets. The figures are in the Federal Reserve publications. That is what they said basically.

Chairman LaFalce. The primary point I wanted to make was that it was in large part liquid assets, which could be drawn out at any time.

Mr. Evans. Right.

Chairman LaFalce. Not something——

Ms. Kaptur. Such as utility bonds?

Chairman LaFalce. Yes, certainly not real estate or investment in corporations or stock or securities.

Mr. Evans. Could have been short-term commercial paper.

Another thing we have seen is a lot of takeovers that have been financed by foreign borrowers.

Ms. Kaptur. Phillip Morris is one of the recent ones.

Mr. Evans. That is one, yes. That is short-term liquid assets, of course. I don't want to overstate the case, I just think the foreign bond of the United States, real estate and property is much higher than it has been before, and even if it is less than half, it still represents a new dimension we have not had to face in the past.

Chairman LaFalce. Let's give Mr. Carper a chance.

Mr. Carper. Thank you, Mr. Chairman.

I want to ask a question about crowding out. For several years I preached that it would occur. It doesn't seem to have occurred to the extent that I thought it would.

I would like to talk about how in the early 1960's, Federal borrowing in order to pay our deficits took up less than 10 percent of the total savings pie. Today, they take up well over half of the savings pie. Yet we still don't see the kinds of symptoms of crowding out that I had anticipated would occur.

One of the explanations for that is simply that we are borrowing a lot of money overseas that we had not had before. I would like to ask, starting with Mr. Levy, why are we not seeing more symptoms of the crowding out? Is it more than just that we are looking to investors from abroad? What is it all about?

Mr. Levy. Well, we were never as upset about crowding out.

Mr. Carper. I wished I had talked to you earlier.

Mr. Levy. The growth of the money supply really determines the availability of money for financing the Federal deficit or for any other reasons.

It has grown obviously adequately for that. The dollar money supply does not change because some of those dollars are for the time being in Europe or owned by Europeans or anyone else outside the United States.

If you think of money supply as being a demand deposit and currency, and you take a $10 bill to London or Tokyo or anywhere else, it is still currency in circulation, part of our money supply. It will be used perhaps after changing a lot of hands until it gets to somebody, whether that somebody is abroad or here, for some purpose. It has been used in very many cases to finance the debt.

I think there is a confusion of the funds available to finance what needs to be financed in the United States, and the movement of that money in terms of one holder to another.

Mr. Carper. Thank you.

Mr. SINAI. I think we have had a lot of crowding out, just in a different form. Crowding out has its biggest and fullest impact when we are at full employment. We are nowhere near full employment so you don't see the sky-high inflation rates. But we have had a huge crowding out in the trade sector.

Net exports, in real terms, is down $57.5 billion since the fourth quarter 1982 and five previous expansions that lasted this long, net exports were up, averaging an increase of over $2 billion. So we have $60 billion crowding out going on in the trade sector, and that has spilled over to manufacturing and to the tradable goods sector.

I think housing starts are nowhere near where they were in the late 1970's, domestic auto sales except for this aberrant last month are nowhere near where they were. The traditional capital expenditures have been weak, our investment boom was in office machinery, light trucks, and cars. That was our investment boom last year in the equipment side.

So, crowding out has been very much in effect. It is different this time, both high interest rates and the strong dollar gave us the crowding out. Crowding out exists also in a sense of what might have been, what we might have done had we not had the huge portion of savings absorbed by our budget deficits. There is a financial crowding out. If you look at the balance sheets of the corporate sector, they have not been fully restructured and reliquefied in this expansion.

Corporations have been crowded out, prevented from restructuring. I see corporate treasurer after corporate treasurer not extending the maturity of the debt structure, because he keeps thinking interest rates will go lower. They don't make the move, and are stuck with an overhand of difficult balance sheets.

Mr. CARPER. Thank you.

Mr. Evans.

Mr. EVANS. I will agree, the crowding out clearly has come in the trade sector. That is one dimension of it. The other dimension which is also mentioned here is that interest rates are much higher than you would expect. We have now 3- or 4-percent inflation, depending on which number you accept, ordinarily historically that would be short rates of about 6 percent and long rates of 7 percent. We obviously don't have long rates of 7 percent at all, they are 11 or 12 percent, that order of magnitude.

What happened? It means people who borrow, both individuals and businesses, have to pay more for interest. This ties in with some of the earlier discussion about the very low savings rate, what consumers do is they pay for the food and clothing and gasoline and things they purchase on ordinary basis, and they look at their purchases that are mainly debt, obviously mortgages but car payments and so forth, and these purchases total much higher than it would otherwise be. The net effect is we have a lower savings rate.

What happened so far is that we have had what I consider to be an easy monetary policy, rapid growth in money and credit aggregates, and the Fed has sort of bailed out the consumers so far. That is an odd manifestation, that is not what economists thought when they said crowding out 5 years ago.

But I think I used to make speeches like that, too, as a matter of fact. We have had——

Mr. Carper. I think that is where I got the idea.

Mr. Evans. That must be it.

We have had two factors. One is the foreign trade deficit, and that will go away, I think, now that the Fed and G-5 have announced that the dollar is going to go down. The other is the very low personal savings rate, and I think here we are going to see consumers eventually have to retrench.

My testimony was just that it would be later rather than sooner; it won't happen next year. Eventually they will have to work out and we will have to find a higher amount of savings from some sector, whether it is individuals, businesses or government, to replace the loss of savings we have from the foreign sector.

If we don't do that, we will be able to meet again next year and give the crowding out speeches again.

Mr. Carper. Thank you.

Chairman LaFalce. I think you said that just because the dollar is going down, the trade deficit isn't going to be abolished. I am not as sanguine as you are about that.

Of the total trade deficit, Japan accounts for what percent—almost a third, right?

Mr. Evans. What is this now?

Chairman LaFalce. Our total trade deficit accounts for a third with Japan.

Mr. Evans. About a third, yes.

Chairman LaFalce. As far as the trade deficit is concerned, the overvaluation of the dollar vis-a-vis the yen was maybe around 15 percent or so rather than 40, 50, 60, or 70 percent against other countries or against the market basket.

With respect to our largest trading partner, Canada, though, which makes all the other countries in the world look, other than Japan, relatively insignificant, we have a trade deficit of $25 billion with Canada.

It is my understanding that there has been little movement of the exchange rate with respect to the Canadian dollar since the G-5 agreement. There hasn't been that much movement at all.

Mr. Evans. Not much with the Canadian dollar, right.

Mr. Sinai. That is right.

Chairman LaFalce. Also, of course, the dollar is strictly a macroeconomic reason for the trade difficulties. It doesn't address microeconomic reasons for our trade difficulties, which, I think, have been a significant factor.

So I am not as sanguine as you that the trade deficit, because of decisions of G-5 and the Presidential $300 million industrial policy initiative, is going to do that much good.

Mr. Evans. I don't think the trade deficit—it will be with us for many years, but the peak of $150 billion that we reached, we will see that reduced to $120 billion and possibly less in the next 2 years. That is at least an improvement, but I don't think it will go away. I don't think any economist believes that.

Chairman LaFalce. How would you rate the recovery that we have experienced following the 1981-82 recession with historic recoveries that we have had? Is it the big-boom recovery of the centu-

ry? Is it less of a recovery than we have had historically, or is it remarkably average, as Mr. Penner said?

Mr. EVANS. It has been average so far in the aggregate. The increase in GNP, however, the first six quarters was slightly higher than average, 7 percent compared to 6.2 percent average in the first 1½ years.

Then the slowdown that we have had is also typical except it lasted one quarter longer. They have always lasted three quarters. For some reason this lasted four quarters.

Chairman LAFALCE. The big boom of 1983 and 1984 of roughly 7 percent was not that unusual.

Mr. EVANS. No, it was quite in keeping with the average, less than 1 percent more than the typical boom.

Chairman LAFALCE. Couldn't one argue that because the recession was far greater than average, that the recovery should have been more than remarkably average?

Mr. EVANS. Well, the reason that it was only slightly above average, I would say, was, first of all, the high interest rates still had negative effects on the economy. Second, we did have a tremendous increase in the trade deficit over 1983 and 1984. And those two factors offset the boom that we might otherwise have had from a deep recession.

Chairman LAFALCE. Mr. Sinai.

Mr. SINAI. I think regardless of what the averages show, it is a very disappointing expansion.

A lot of one's perspective depends on the time you look at it. If you look at 1982, you gave Reaganomics an "F" because things went badly. If you look at 1984, in November, you gave it a high grade. As we look at it in 1985, which doesn't count that much more, the election year, it would be low. And by 1986, it would look good again.

It looks to me to be, as an economist, very disappointing in a number of ways. It has been unbalanced. It has been lopsided. It is unbalanced across industries and sectors. It is unbalanced across regions. It is unbalanced between goods and services. It is unbalanced in who you employ.

Part and parcel of this episode is accumulating debt. The volatility is extraordinary.

The one good thing is the decline in inflation considering the episodes we have been through, and that offers a lot of opportunity for the future.

Chairman LAFALCE. Let me follow up with another question. This has to do with the trade deficit.

One of the reasons I am not as sanguine that we will bounce back because of the lowering in the value of the dollar is because of what I think is something that hasn't been adequately considered—that is the permanency of the damage done to the industries that have historically been involved in export markets, the irreversibility of that damage, and therefore the irreversibility of the loss of a good portion of the market share which historically has been ours, and the inability to reestablish the industries and to regain some of those lost markets.

So I am just not confident that we can look at the flow of the dollar and say, if the value of the dollar comes down, we automatically, therefore, will go up, because I don't know that our industries are poised.

I think a good many of our industries have made investment decisions over the years that outsource the production of goods and services overseas that will not come back to the United States, even with a lower valued dollar.

Comments on that?

Mr. **Sinai**. I agree with that. There is some theoretical value to which the dollar would fall. The price system works, and you would eventually get a good reversal.

We have had a unique set of circumstances in this country, very unusual policy mix, unusually real high interest rates, and structural changes that you describe are largely permanent, and we have—might as well accept it—ceded to the rest of the world a big chunk of our industrial capacity and ability to produce, and that is just the way life is going to be from now on. We will have to go on from there.

If one regards that as a negative, as many people do, that is what has happened. It is a fait accompli. There isn't going to be much in the movement of the dollar, and even that is questionable, whether intervention can achieve anything anyway.

Chairman **LaFalce**. A big difference between coordinated intervention to deal with gyrations in the value of the dollar and some type of change in the international monetary scheme.

Mr. **Sinai**. Exactly right. The latter has not been a question.

Chairman **LaFalce**. Not at all.

Mr. **Evans**. I agree with you. I will send a paper I wrote on this issue.

We lost 1.5 million manufacturing jobs. I am not debating that. I don't think that a long-term equilibrium solution of a trade deficit of $100 billion is what I would order if I were the economic czar and had my choice. I don't think that is good.

The point I want to make is that there are some areas where we were priced out of world markets for no good reason other than the overvaluation of the dollar.

The prime example is agriculture. We have high productivity and should be a leader in exporting. The price of agricultural products, however, is not even close with the dollar where it was. When it goes back down, our exports in agriculture will pick up.

I think in certain areas consumer goods will—consumers do value price, so there will be a turnaround. Machine tools, we lost the battle. Machine tool imports are now 40 percent. They used to be 20 percent just a few years ago. We won't get that back.

Chairman **LaFalce**. I saw Houdaille is going out of the machine tool business.

Mr. **Evans**. Exactly. That was on my mind when I said that.

So there are certainly a lot of long-term permanent shifts that are inimical to the manufacturing sector that are going to stay.

My point is there is still flexibility, areas where relative prices are more important, and we will see improvement there.

Chairman **LaFalce**. Let me ask you for assistance in this. I am going to conduct hearings probably in January and February that investigates the permanent damage that has been done to the economy because of the recession of 1981-82, and the macro- and microeconomic policies, that we have been following.

How will we ascertain the permanency of the damage? How will I gain that data and information and make an appropriate valuation?

Can you give me any insights, if not now, later?

Mr. LEVY. I think there are some problems that may be more and some less permanent.

For example, going back to our major export, farm products, you know we blithely assume, and there was speculation in land and so forth, on the basis that export markets for which the larger parts of important crops would expand forever.

Two things happened. One is that a lot of countries increased their own production so they didn't have to import so much and themselves became exporters in a few cases where they had been importers; and, of course, exporting countries, like Argentina, increased their output and were able to compete with us.

Now, I would agree that we will get back some of these markets if the dollar goes down, but we may not. Then again, if the world population keeps growing and it turns out that the advances made in the rest of the world in agriculture are not adequate to keep pace with the growth of the population, which would seem to be the case at least in some places, we might have a revival for that reason in our agricultural exports.

I think, you know, that I view that the dollar from an economic point of view is in the right place when efficient American industries have no disadvantage competing with other equally efficient companies in other countries. But we may never get there.

I picked up the Sunday paper and read about riots in England and read about riots in many cities in Germany in the paper this morning. I was struck by the fact that there are a lot of people in these, the most stable countries among our industrial allies, who will want to hold their wealth in dollars rather than in any other way.

As long as that kind of situation exists in the world, it is going to be very hard to keep the dollar at a level in which competitive—I mean, efficient, American industries can compete with equally efficient industries abroad. Whether these industries are agricultural or manufacturing, the same applies.

Chairman LAFALCE. All of you based your forecasts on certain economic assumptions, of course.

Mr. Evans, you are the most optimistic of the three forecasts. Which ones worry you most?

Mr. EVANS. I think that the dollar will continue to go down, so I feel strongly about that assumption.

Where I feel uneasy is what the ultimate federal policy will be in reaction to that.

Chairman LAFALCE. Mr. Sinai—or who said it was a fairly liberal situation? You did, right?

Mr. EVANS. I think the Fed has had an easy monetary policy for the last 3 years.

Chairman LAFALCE. Do you agree with that, Mr. Sinai?

Mr. SINAI. No, but I think we are looking at different ways of judging it and my guess is——

Mr. LEVY. Obviously.

Mr. SINAI. One is the growth of the money supply, and I am looking at it in terms of real interest rates.

Chairman LAFALCE. And you, Mr. Levy, would you agree with Mr. Sinai on that issue?

Mr. LEVY. Right.

Mr. EVANS. OK. Fair enough.

Mr. SINAI. Just that we are right and he is wrong.

Mr. EVANS. In any case, I am puzzled.

Chairman LAFALCE. I don't know much about economics, but that answer I can handle.

Mr. EVANS. I am wondering what the Fed will do next, though.

Let's assume that my economic scenario works out that we have faster growth and faster inflation and the dollar goes down. Then the question is, sometime around the middle of next year, will the Fed reassess everything? "Wait a minute; the economy is doing well but inflation is worse, the dollar is weak, much like we want it, and money growth is growing rapidly, so now it is time to tighten up." I don't know if they will do that.

My forecast assumes they won't. But that is the weakest link in the forecast because it is quite possible that they would decide to tighten up, rediscover the money supply, and get back to the old-time religion and throw the economy into a recession.

We don't have a good gauge of what the Volcker Fed will do because they have been doing so many things over the past 6 years. I am not saying it is good or bad, but it is a fact there is no consistent pattern to monetary policy.

So it might well be that we would not have a continuation of the boom because of substantial tightening in policy. You agree, it could be tightened substantially from what it is now regardless of how I characterize it as now.

Mr. SINAI. Right.

Chairman LAFALCE. What are the economic assumptions you use that worry you.

Mr. SINAI. I think we know the least about the response to a dollar decline and potentially a cumulative dollar decline. Will the Japanese buy United States Treasury securities the way they have been before now that they expect depreciation on the dollar?

We don't know because we have a financing in a couple weeks that is delayed; it is working its way through Congress and we don't know if they withdraw their funds, though we could get higher interest rates. We don't know, and I think the Federal Reserve isn't sure how they should respond, although for sure, if the dollar keeps sliding at the pace it is, the central bank will not ease.

We have episodes which Mr. Evans cited, in which the dollar went down. We had strong responses of inflation, perhaps not only due to the dollar, and we could set up a boom-bust situation. That is the weakest area of the forecast.

For the numbers we have had in there, I feel reasonably comfortable with the policy assumptions. They seem rational. But what I don't know is the process I have just described.

Chairman LAFALCE. What would happen if we had a lot more bankruptcy in our agricultural sector, or if we had some severe rupturing of our farm credit system? What would happen if we had a rash of financial institutions, savings and loans, thrifts, and commercial banks go under, or if FDIC or FSLIC finds financial reserves are not adequate and they have to come to a reserve decision?

If Congress came to the assistance of it and there is a drop in——

Mr. SINAI. You have put your finger on something none of us has mentioned so far.

Chairman LAFALCE. What happens if Third World countries can't export to the United States nearly as much because of first, protectionism, and second, lower value of the dollar? They can't access the international marketplace as much because the United States has become more competitive with other countries, and we have some type of—I don't want to say explosion—but a lightening up of the liquidity problem, and solvency problems of some of the Third World countries. What happens?

Mr. SINAI. The risk is in thinking that the international difficulties will work themselves out. That is a big risk in anybody's forecast. It is an area that we, I think, economists and the United States, have fairly little experience with.

What you describe is the fallout of a deeper problem, policy imbalance, but a problem that stems from the fact we have so open an economy. We have had such strong impacts because of the dollar.

Now, maybe the dollar decline will relieve through firm commodity prices a lot of the farmers now on the brink. It won't help those that have been pushed out of business. It may be that we will kind of arrest the deterioration that you describe.

Really, you are describing a potential depression process. What I am saying is, having had very little experience with ups and downs of the dollar and what the effects are and the policy we have been running, that is where I worry most about the forecast going wrong and getting into some sort of catastrophe that we might have missed.

Chairman LAFALCE. Mr. Levy.

Mr. LEVY. Well, I, as I indicated earlier, I am stressing saving. I think I indicated that this is one of the elements that is the weakest part of our forecast because, frankly, we don't understand why the savings rate is as low as it is, and not understanding why it is low, we can't be sure that it is going to return to something more usual.

I would put in second place what Allen Sinai put in first place, the effect of the declining dollar on the trade deficit.

The other problem, you know, the financial crises are certainly not going to help anything, but I think that they will be after the fact; in other words, if they are very widespread and not confined just to agriculture.

Chairman LAFALCE. Thank you very much, Mr. Levy.

I want to thank all members of the panel. This has been extremely educational and interesting for me. I suspect other members of the subcommittee feel the same way.

Mr. Sinai, you are going to give me information on debt.

Mr. SINAI. Yes.

[In response to the request of Chairman LaFalce, the following information was submitted for the record by Mr. Sinai:]

Summary of Outstanding Bank Loans to Heavily Indebted Countries
(Billions of U.S. Dollars, Except as Noted)

Country	1983		1984		Percent Change	
	All Banks	U.S. Banks	All Banks	U.S. Banks	All Banks	U.S. Banks
Mexico	89.8	25.4	89.9	25.8	0.1	1.4
Brazil	85.6	21.6	93.2	24.8	8.9	14.9
Argentina	26.6	8.8	25.1	8.4	-5.5	-4.7
Philippines	15.1	5.5	14.8	5.1	-1.8	-7.4
Venezuela	24.2	10.9	24.1	10.6	-0.5	-3.1
Columbia	4.7	3.6	5.3	3.0	10.8	-15.6
Ecuador	4.8	2.0	5.4	1.5	12.4	-2.8
Chile	14.9	5.9	16.7	6.4	11.9	7.6
Peru	4.7	2.3	4.9	2.1	4.7	-7.9
Bolivia	1.8	0.3	1.7	0.2	-8.2	-34.9
Nicaragua	2.3	0.1	2.4	0.1	3.5	0.0
Honduras	0.6	0.1	0.7	0.1	13.6	-13.9
Total	275.0	86.5	284.1	88.5	3.3	2.3

Note: *Excludes official loans, loans from multilateral organizations, and bilateral and supplier credits.*

Sources: *International Monetary Fund and Morgan Guaranty Trust Co*

The 15 Middle-Income Debtors

Country	GDP per Capita, 1981* (U.S. Dollars)	Gross Debt, 1984 (Billions of U.S.Dollars)	Debt Service Ratio,*** 1984 (Percent)
Argentina	4,333	47.8	251.4
Bolivia	1,073	4.1	133.2
Brazil	2,132	102.2	85.1
Chile	2,215**	20.4	123.6
Colombia	1,361	12.5	118.3
Ecuador	1,587	7.6	104.5
Ivory Coast	996	9.7	131.7
Mexico	3,367	96.7	138.5
Morocco	730	13.6	54.5
Nigeria	850	21.0	95.9
Peru	1,133	13.8	113.5
Philippines	780	25.8	176.0
Uruguay	3,837	4.7	166.9
Venezuela	4,292	32.4	110.7
Yugoslavia	2,810	19.3	34.5
Average	2,100	28.8	122.6
Total	—	431.6	—

* *Converted at 1981 prices and exchange rates.*

** *Exchange rate for 1982 used to reflect purchasing power.*

*** *Total debt service, including short-term debt, as a percent of exports.*

Sources: International Monetary Fund; Morgan Guaranty Trust Company

Typical Countries Included in the Trust Fund for Sub-Saharan Africa

Country	GDP per Capita, 1981* (U.S. Dollars)	Gross Debt, 1984 (Billions of U.S.Dollars)	Debt Service Ratio,**** 1984 (Percent)
Angola	—	—	—
Benin	300	—	—
Burundi	252	—	—
Cameroon	—	—	—
C. African Republic	—	—	—
Chad	—	—	—
Congo	—	—	—
Ethiopia	135	—	—
Gabon	3,434	1.0	13.8
Gambia, The	342	—	—
Ghana	500**	2.0	60.3
Kenya	385	—	—
Liberia	450	0.8	—
Madagascar	315	2.1	—
Malawi	185	1.0	—
Mali	—	—	—
Mauritania	424***	—	—
Mauritius	1,215	—	—
Mozambique	—	—	—
Niger	403	—	—
Rwanda	239	—	—
Sao Tome & Principe	—	—	—
Senegal	420	1.9	—
Seychelles	2,387	—	—
Sierra Leone	327	—	—
Somalia	—	—	—
Sudan	276	8.3	104.1
Tanzania	286	—	—
Togo	364	1.0	—
Tunisia	1,293	4.7	32.1
Uganda	—	—	—
Zaire	176	5.4	67.3
Zambia	711	3.8	—
Zimbabwe	864	2.5	56.9
Average	461	0.9	8.2
Total	—	34.5	—

[*] *Converted at 1981 prices and exchange rates.*

[**] *Exchange rate for 1982 used to reflect purchasing power.*

[***] *Data available for 1980 only.*

[****] *Total debt service, including short-term debt, as a percent of exports.*

Sources: International Monetary Fund; Morgan Guaranty Trust Company

Financing Capital Expenditures
Nonfinancial Corporations
(Billions of Dollars, SAAR, Except When Noted)

	Years			Quarters		
	1982	1983	1984	1985:1	1985:2	1985:3
Capital Outlays						
Plant and Equipment	241.1	244.3	307.9	328.9	342.9	343.6
Annual Rate of Change (%)		1.3	26.0	3.1	18.1	0.9
Inventory Change (Before IVA)	-12.7	8.1	52.1	33.5	8.4	-6.3
Residential	2.9	7.4	5.6	6.2	6.0	5.7
Total	231.3	259.8	365.6	368.7	357.3	343.0
Annual Rate of Change (%)		12.3	40.7	12.9	-11.8	-15.1
Internal Funds						
Aftertax Profits +	79.4	90.9	113.8	107.1	101.5	106.9
Inventory Valuation Adjustment -	-9.5	-11.2	-5.7	0.9	2.5	7.2
Dividends =	69.0	72.2	79.5	83.1	84.2	84.9
Retained Earnings +	0.9	7.4	28.7	24.9	19.8	29.2
Depreciation(1) +	211.1	248.3	283.1	305.9	315.3	326.0
Foreign Earnings =	12.6	9.9	8.9	10.3	0.8	7.7
Internal Funds	224.6	265.7	320.6	341.1	335.9	362.9
Annual Rate of Change (%)		18.3	20.7	11.5	-6.0	36.3
Financing Gap (Capital Outlays less Internal Funds)	6.7	-5.9	45.0	27.6	21.4	-19.9
External Financing	83.3	82.8	104.7	59.7	55.0	23.5
Debt	71.9	54.5	181.7	144.0	122.1	98.5
Short-Term	39.4	26.1	120.6	76.2	32.5	18.9
Bank Loans	41.5	18.9	77.2	34.0	22.6	27.6
Open Market Paper	-5.4	-1.2	22.7	15.6	11.4	-0.8
Finance Co. Loans	2.0	8.9	19.5	18.9	0.9	-13.6
U.S. Govt. Loans	1.3	-0.5	1.2	6.8	-2.4	5.6
Long-Term	32.5	28.4	61.1	67.8	89.6	79.6
Corp. Bonds	33.8	25.5	60.8	67.3	89.2	79.9
Mortgages	-1.3	2.9	0.3	0.5	0.3	-0.3
Equity	11.4	28.3	-77.0	-84.3	-67.1	-75.0
Ratios (Percent)						
Flows						
Cash Flow/Capital Outlays	97.1	102.3	87.7	92.5	94.0	105.8
External Financing/Capital Outlays	36.0	31.9	28.6	16.2	15.4	6.9
External Financing/Cash Flow	37.1	31.2	32.7	17.5	16.4	6.5
Short-Term/Total Debt	54.8	47.9	66.4	52.9	26.6	19.2
Long-Term/Total Debt	45.2	52.1	33.6	47.1	73.4	80.8
Short-Term/External Financing	47.3	31.5	115.2	127.7	59.1	80.3
Long-Term/External Financing	39.0	34.3	58.4	113.6	163.0	338.5
Equity/External Financing	13.7	34.2	-73.5	-141.3	-122.1	-318.8
Debt Service/Cash Flow	51.3	46.2	41.5	39.1	42.4	40.4
Stocks						
Quick Ratio (Short-Term Assets/Liabilities)	39.5	46.2	43.2	39.3	39.0	37.1
Short-Term/Total Debt	49.8	48.9	51.3	51.7	51.1	52.6
Long-Term/Total Debt	50.2	51.1	48.7	48.3	48.9	47.4
Short-Term/Long-Term	99.3	95.6	105.6	107.0	104.6	111.0
Short-Term/External Debt	39.6	38.4	42.4	44.6	44.7	46.2
Long-Term/External Debt	39.8	40.2	40.1	41.7	42.8	41.6
Equity/External Debt	20.6	21.4	17.5	13.7	12.5	12.1
Debt/Equity (Net Worth)	106.6	103.4	107.8	110.9	110.8	109.7

Chairman **LaFalce**. Mr. Evans you are going to give me information on the million-and-a-half jobs and the permanancy of the damage.

Mr. **Evans**. It is a fairly detailed study.

Chairman **LaFalce**. Thank you. The subcommittee is adjourned.

[Whereupon, at 12:35 p.m., the subcommittee adjourned, subject to the call of the Chair.]

[The study submitted for the record by Mr. Evans entitled "Trade Deficits are Forever" follows:]

TRADE DEFICITS ARE FOREVER

However, the fourth cylinder simply will not fire correctly. For against this formidable array of optimism, the pessimists stand undaunted. They claim the economy cannot respond properly even to massive doses of monetary stimulus because of the overwhelming leakage of imports. On the face of it this does not seem to be reasonable, since the economy was able to expand at an 8% rate during much of 1983 and early 1984 in spite of the decline in constant-dollar net exports of $6 billion per quarter. Nonetheless, it is clear that the burgeoning trade deficit is quite serious in the longer run, so this month we examine the leakages in more detail, calculating the number of jobs lost and the sectors in which imports have grown the most in order to determine how much the continued strength of the dollar will hurt the U. S. economy in future years.

When the Fed cut the discount rate last month and stated that its priorities had shifted and the overvalued dollar and concomitant weakness of the manufacturing sector were now of greater importance, it merely made official what most economists had long realized — that the increases in manufacturing production and employment simply have not kept pace with the overall expansion of the economy during the past several years. The overall figures can be summarized as follows. From the peak in 1973.4 until the next peak in 1979.2, manufacturing employment rose 0.82 million; from that date until the present, employment has fallen 1.64 million. Furthermore, if we take a weighted average of all the components of final demand that affect the manufacturing sector, real growth has been more than 1% per year higher in the latter period. Thus if productivity growth had been the same over these two periods, which is approximately the case — if anything, productivity growth in the more recent period has been more anemic — employment should have risen at least 1/2% per year more, or by an additional 0.60 million workers. As a result, we calculate that approximately 3 million jobs have been lost to higher imports and lower exports over the past six years.

This may sound somewhat like back-of-the=envelope calculations, but in fact Table I presents very detailed 2-digit (and in the case of iron and steel and automobiles, 3-digit) estimates of employment under various alternative economic assumptions. This table, which forms the centerpiece of this section of the ANALYSIS, can be described as follows.

The first six columns record industry employment for the following quarters: 1973.4, 1975.2, 1977.3, 1979.2, 1981.3, and 1983.1. Most of these are easily identified. The first two represent the peak and trough in manufacturing employment for the 1971-75 business cycle; note in particular that manufacturing employment troughed one quarter after the lower turning point had been reached. business cycle. The 1977.3 column gives employment figures nine quarters later; these increases can then be compared to the increases in manufacturing employment thus far in the current business cycle, which has now completed its ninth quarter. The 1979.2 column represents the all-time as well as the cyclical peak in manufacturing employment. 1981.3 then represents a secondary peak; the economy staged a very brief recovery that lasted from approximately mid-1980 to mid-1981, but, manufacturing employment was already almost 1 million below the 1979 peak. The 1983.1 column is the trough in manufacturing employment following the Great Recession; once again, note the one-quarter lag. The "latest" column represents an average of employment for March, April, and May of 1985. All figures are based on the recent BLS benchmark, which not so incidentally lowered total manufacturing employment by 0.2 million.

The last three columns of Table 1 contain our results and conclusions. Column (8) indicates what manufacturing employment would have been in the latest three-month period if it had simply continue to increase at the same rate as occurred in the 1973.4-1979.2 period. The calculations underlying Column (9) are somewhat more complicated. We first calculated the increase in the components of domestic final demand that correspond to each industry, using the input/output table coefficients; for example, machinery was obviously tied to the machinery components of producers durable equipment, apparel to the consumption of clothing, chemicals to almost every type of goods, and so on. Assuming the same annual growth rate in productivity in both subperiods, which we have already indicated is a reasonable assumption, column (9) then shows what level of employment would have occurred under the assumption that imports and exports remained at their 1979.2 proportion of GNP. Column (10), which is simply (7) - (9), represents our estimate of the loss of jobs due to increased import competition. As can be seen, the total loss of jobs is just over 3 million.

As would be expected, the job losses are concentrated in the metals and machinery areas. Our calculations show that fabricated metal products, which are extremely vulnerable to overseas operations, lost 0.49 million jobs. The machiney sector lost 0.60 million, much of it in the engines and parts category. In the metals industry, the steel industry lost 0.22 million jobs, while for nonferrous metals the figure is 0.10 million. The estimated loss for motor vehicles is 0.31 million jobs; for other transportation equipment, which also includes defense and space workers, the loss is a much smaller 0.06 million, partly because this country still maintains its competitive edge in aircraft and partly because, at least so far, defense procurement jobs do not go to foreigners. These four industries account for about 1.8 of the 3.0 million jobs lost, or about 60%. The rest of the losses are scattered throughout the manufacturing sector. The food, textiles, apparel, and paper industries have each lost about 0.10 million jobs to foreign competition since 1979, while the figure is about 0.15 million for the chemicals and rubber/plastics industries.

Table 1
Loss of Manufacturing Jobs Due to Increased Imports

	(1) 1973.4	(2) 1975.2	(3) 1977.3	(4) 1979.2	(5) 1981.3	(6) 1983.1	(7) Latest 1985.2	(8) Extrapolating 73-79 trend	(9) Total Of Import Share Constant	(10) Loss of Jobs
Total manufacturing	20.30	18.12	19.78	21.12	20.29	18.06	19.48	22.08	22.52	-3.04
Lumber	0.65	0.60	0.72	0.77	0.67	0.61	0.70	0.91	0.81	-0.11
Furniture	0.54	0.41	0.47	0.50	0.47	0.43	0.50	0.46	0.54	-0.04
Stone, clay & glass	0.70	0.62	0.67	0.71	0.64	0.56	0.60	0.72	0.76	-0.16
Iron & Steel	0.62	0.57	0.55	0.58	0.51	0.34	0.31	0.54	0.53	-0.22
Other primary metals	0.74	0.61	0.63	0.68	0.62	0.47	0.52	0.62	0.62	-0.10
Fabricated metals	1.53	1.45	1.59	1.73	1.60	1.34	1.48	1.93	1.97	-0.49
Nonelectric machinery	2.16	2.06	2.19	2.49	2.52	2.00	2.21	2.87	2.81	-0.60
Electric machinery	2.07	1.68	1.90	2.11	2.11	1.96	2.23	2.15	2.28	-0.05
Motor vehicles	0.96	0.77	0.95	1.04	0.78	0.70	0.87	1.12	1.18	-0.31
Other Trans. Equipment	1.09	0.94	0.96	1.07	1.13	0.98	1.11	1.05	1.17	-0.06
Instruments	0.51	0.54	0.62	0.69	0.74	0.69	0.73	0.93	0.81	-0.08
Misc. Manfacturers	0.45	0.40	0.43	0.44	0.41	0.36	0.38	0.43	0.46	-0.08
Food	1.73	1.65	1.71	1.73	1.66	1.61	1.63	1.73	1.73	-0.10
Tobacco	0.08	0.07	0.07	0.07	0.07	0.07	0.07	0.06	0.07	0
Textiles	1.03	0.85	0.91	0.89	0.83	0.73	0.70	0.75	0.79	-0.09
Apparel	1.40	1.21	1.32	1.31	1.26	1.14	1.16	1.22	1.26	-0.10
Paper	0.70	0.63	0.69	0.71	0.69	0.65	0.68	0.72	0.77	-0.09
Printing	1.11	1.08	1.15	1.23	1.27	1.28	1.41	1.35	1.41	0
Chemicals	1.04	1.01	1.08	1.11	1.11	1.05	1.05	1.18	1.22	-0.17
Petroleum	0.20	0.19	0.20	0.21	0.21	0.20	0.18	0.22	0.18	0
Rubber & Plastics	0.68	0.59	0.72	0.79	0.75	0.68	0.79	0.90	0.93	-0.14
Leather	0.29	0.24	0.25	0.25	0.24	0.21	0.17	0.21	0.22	-0.05

Col. (8) Total number of jobs if percentage increase had been the same in 1979.2-1985.2 as in 1973.4-1979.2.
Col. (9) Total number of jobs if imports had remained same proportion of final demand as occurred in [illegible]
All figures in millions of [illegible]

Returning for a moment to the aggregate figures, we find that from 1973.4 to 1977.3, which was the ninth quarter of the previous recovery, manufacturing employment slumped from 20.30 to 19.78 million workers. From 1981.3 to 1985.2, which covers an almost identical time span, manufacturing employmend declined from 20.29 to 19.48 million, or about 0.30 million more. Seen in this perspective, the two cycles might not look so dissimilar. However, the following factors must also be considered. First, as shown in Table 2 the increase in this cycle has been somewhat more robust than the previous upturn, so that other things being equal, employment should have grown more. Second, in the 1977.3-1979.2 period, manufacturing employment received a substantial boost from the improvement in the net export balance due to the sharply declining dollar, a factor that hardly seems in the cards for this business cycle.

Second, manufacturing employment declined almost 1 million between the two cyclical peaks of 1979.2 and 1981.3, even though domestic demand for goods rose somewhat in the interim period. In other words, the erosion of jobs started even before the strength of the dollar became noticeable. This development occurred for several reasons, including the double-digit inflation that was ravaging the country at the time; the apparently out-of-control increases in factor costs, including labor costs; and the unfavorable tax treatment for purchasing new industrial plant or equipment.

Third, the increase in manufacturing jobs — at least until early 1985 — had been proceeding apace with other business cycle recoveries in which foreign competition had not had such a deleterious effect. After all, for most business cycles, an increase of 1 1/2 million jobs in manufacturing during the first two years of recovery would be adjudged quite successful. The problem is that the gains should have been even larger, given the above-average strength of the first

Table 2
Growth Rates of Components of Final Demand Relating to Manufacturing Sector

	1973.3	1979.1	% growth, annual rate	1985.1	% growth, annual rate
Consumption of autos and parts	55.6	66.2	3.2	77.1	2.6
Consumption of furniture and household durables	46.5	58.6	4.3	80.2	5.4
Consumption of other durables	18.7	23.8	4.5	29.1	3.4
Consumption of food*	153.5	173.8	2.3	196.8	2.1
Consumption of clothing	59.2	75.1	4.4	97.9	4.5
Machinery component of PDE excluding computers	45.3	53.9	3.2	51.7	-0.7
Computers	5.7	14.8	18.9	38.8	17.4
Autos and truck component of PDE	20.2	23.9	3.1	31.8	4.9
Other transportation equipment	6.1	6.8	2.0	4.4	-7.0
Instruments componet of PDE	5.8	9.6	9.6	12.8	4.9
Defense purchases - durables	13.7	17.4	4.4	28.1	8.3
Total goods shown above	353.6	437.0	3.9	550.3	3.9
Single-family homes	27.1	29.5	1.6	27.7	-1.0
Multi-family homes	18.0	8.7	-12.4	11.6	4.9
Nonresidential construction	48.3	46.6	-0.6	60.8	4.5
Government construction	30.8	24.0	-4.4	22.5	-1.1
Total construction shown above	124.2	108.8	-2.4	122.6	2.0
Total construction and goods shown above	477.8	545.8	2.4	672.9	3.6

Note these are lagged one quarter behind the employment statistics given in Table 1.

All figures in billions of 1972 $ except % changes

*Figures divided by 2 for inclusion in "Total goods shown above" categoy leg of the recovery. More serious, the recent decline in manufacturing and the continued increase of the dollar in 1984 and early 1985 are both signals that the gains in manufacturing employment over the next two years will be severely limited even if the economy remains healthy and the dollar does decline as much as 20%.

To see this, we now look at the industry data in greater detail. The reasons for the decline in net exports can be divided into three separate categories, two of which are not likely to be solved by a weaker dollar. The one that is, namely the choice of imported goods strictly based on price, applied mainly to commodities such as lumber, paper, and chemicals, and nonferrous metals; if the dollar were to decline 20%, these industries would regain much of their market share, and if it were to decline 40%, they would once again be fully competitive. To a certain extent, one should be able to make the same argument for steel, but this situation is complicated by the new import quotas. While the steel industry may think they are ineffective, the damage would be much worse in the absence of any quotas whatsoever. Since steel imports are currently restricted at least in part by fiat rather than by market forces, even a substantial decline in the dollar would not solve this problem. Indeed, we see no long-term solution for the steel industry other than to shrink even further and increase domestic reliance on minimill technology.

However, the problems are even more intractable for the major areas in which jobs have been lost; fabricated metal parts, machinery, and motor vehicles. In the case of the first two industries, much of the new capacity being built is coming on stream overseas; thus Brazil, Mexico, Taiwan, and Korea get the most modern equipment and technology, while facilities in the U. S. become even more obsolete. Even if the dollar were to return to what we used to think was its equilibrium value -- which would be 35% to 40% below current values --

these modern plants overseas would still be able to compete effectively. Furthermore, much of the capacity that has been transferred to other countries has resulted in shutdowns of domestic plants, which could not be reactivated even under more favorable exchange rate conditions. This analysis basically applies to fabricated metal products, engines, and machinery parts -- as opposed to finished products.

The final problem, which centers on what could be called brand-name finished products, of which autos are the leading example, is not so much one of facilities moving overseas, since much of the the assembly and distribution is still done in this country, but rather a marked preference for foreign-made machinery and transportation equipment. In some cases price is the principal determining factor, but more often it is the preference for a particular make or model because of perceived superiority of the foreign product. Of course this image has been carefully nurtured by years of advertising, but it is also reflected in consumer surveys and repair records, such as those published by J. D. Power & Co., which consistently show Mercedes, Toyota, and Honda — although not Datsun/Nissan — among the cars with top repair records. Whatever the exact blend of perception and reality, these markets will not shrink even if the dollar were to decline as much as 20%. With the astronomical profit margins on many of these cars, foreign producers have plenty of room to cut their domestically based prices — i.e., fully offset the decline in the dollar — and still post above-average returns. Also, having fought vigorously for market share, these countries obviously will not retreat because of what they view as a minor and temporary readjustment in the value of the dollar.

Further evidence that the appearance of large trade deficits is irreversible can be seen by examining those figures for the increase in import penetration that has taken place over the past three years. These figures are given in Tables 3 and 4 by country and by type of product. We turn first to the country figures.

Table 3
Decline in Net Trade Balance by Region

	1982.2 Export	1982.2 Import	1982.2 Balance	1985.2 Export	1985.2 Import	1985.2 Balance	Net Change 1982.2-85.2
Canada	33.9	48.2	-14.4	46.6	69.6	-23.0	-8.6
United Kingdom	11.4	13.1	-1.7	13.2	14.1	-0.9	+0.8
Germany	9.6	13.0	-3.4	9.7	20.3	-10.6	-7.2
Rest of Europe	41.6	29.0	12.6	33.8	46.8	-13.0	-25.6
Japan	20.5	39.7	-19.2	23.4	69.2	-45.8	-26.6
Taiwan & Korea	11.2	16.9	-5.7	14.7	29.8	-15.1	-9.4
Mexico	14.3	15.3	-1.0	13.5	20.1	-6.6	-5.6
Rest of Latin America	19.3	16.1	3.2	15.9	30.3	-14.4	-17.6
OPEC countries	23.7	26.9	-3.2	12.8	22.4	-9.6	-6.4
Rest of Asia and Africa	34.4	19.3	15.1	31.0	34.2	-3.2	-18.3
All Third World Countries*	91.7	77.6	14.1	73.2	107.0	-33.8	-47.9
Total U.S. Economy	219.8	237.5	-17.7	214.6	356.8	-142.2	-124.5

*Sum of above four lines

All figures in billion of 1972 dollars, seasonally adjusted at annual rates.

Table 4

Decline in Net Trade Balance by Commodity and Industry

	1982.2			1985.2			Net Change
	Export	Import	Balance	Export	Import	Balance	1982.2-85.
Agricultural (a)	30.7	18.8	11.9	23.3	26.4	-3.1	-15.0
Crude materials excl. fuel	20.9	9.1	11.8	16.8	11.2	5.6	-6.2
Fuels	13.7	55.6	-41.9	9.3	53.7	-44.4	-2.5
Chemicals	21.1	9.6	11.5	21.8	16.2	5.6	-5.9
Semi-finished Goods	18.3	35.0	-16.7	13.8	49.6	-35.8	-19.1
Machinery and Equipment	88.7	76.1	12.6	96.1	137.7	-41.6	-54.2
Motor Vehicles & Parts	16.6	33.1	-16.5	18.2	54.0	-35.8	-19.3
Aircraft	12.2	3.0	9.2	16.6	4.5	12.1	2.9
Electrical Machinery	12.6	10.7	1.9	13.1	18.9	-5.8	-7.7
Semiconductors	4.2	4.3	-0.1	5.1	7.3	-2.2	-2.1
Computers	10.6	3.0E	7.6	16.2	11.6	4.6	-3.0
Electronic Equipment (b)	3.9	10.4E	-6.5	4.6	20.1	-15.5	-9.0
Other Machinery and Trans. Equipment	28.6	11.6	17.0	22.3	21.3	1.0	-16.0
Other Manufactured Goods and Miscellaneous	26.4	33.3	-6.9	33.5	62.0	-28.5	-21.6
Total	219.8	237.5	-17.7	214.6	356.8	-142.2	-124.5

(a) excluding manufactured food products

(b) including radio, TV, hi-fi equipment, and communications equipment

All figures in billions of 1972 dollars, seasonally adjusted at annual rates.

In spite of the loss of jobs in the manufacturing sector in 1980 and 1981, our net export position was basically in balance through mid-1982; while the trade balance was negative, the surplus in services generally pushed the number into the positive zone. However, starting in 1982.3, net exports started to deteriorate unmercifully, a trend which has not yet abated. The principal reasons for this were (a) the lagged effect of the stronger dollar, and (b) the IMF dictat that third world countries seeking aid to refinance their debts must export more and import less. Naturally the countries who were thus chastised interpreted that rule primarily with respect to the United States.

When the imbalance of trade is discussed, the first item that generally comes to mind is the horrendous deficit with Japan. The numbers are indeed immense and are rapidly expanding; for the most recent three months, the figure has ballooned to an annual rate of $45.8 billion. However, Japan can hardly be blamed for the total damage that has occurred to net exports since mid-1982. To be specific, our trade balance has declined by $125 billion over this period; Japan has accounted for $26.6 billion of that total, or just over 20%. As shown in Table 3, the swing in the deficit for Europe has been an even larger $32 billion, with Germany, France, and Italy (the latter two not shown separately) accounting for most of that damage. Taiwan and Korea by themselves have accounted for almost a $10 billion increase in the deficit, while the Third World countries — represented by Africa, Asia, and Latin America excluding the Far East and OPEC — have caused a tremendous $42 billion rise in our trade balance since mid-1982.

It is this swing in the Third World economics that cannot be reversed by a decline in the value of the dollar, precisely because of the strictures imposed by the IMF. Of course these countries could theoretically default on all loans and decide to stop exporting and start importing again, but the U. S. economy in general and the banking system in particular would hardly be better off under that scenario. These countries must literally export to survive, and thus will continue to send out all the goods they can produce and market regardless of the current exchange rate. If the dollar happens to be strong, they are able to pay off a little more of their loans than if it is weak, but that is the extent to which fluctuations in the dollar affect their external position.

As we have mentioned above, the situation for Japan, and to a somewhat lesser extent for Taiwan and Korea, is such that these import surpluses are not likely to disappear if the dollar declines either. The outlook is somewhat brighter for Europe, where in many cases competition is tied more directly to relative prices, and a switch of 20% could tilt trade flows back in our favor; the same general comment applies to Canada.

Even assuming this to be the case, though, the current $142 annual rate trade deficit does not seem amenable to shrinkage by ordinary means. The figures in Table 3 can be aggregated into three groups. The first group represents those countries where relative prices do count, and includes Canada and Europe, with a total deficit of $47 billion, compared to about $7 billion three years ago. We would estimate that as much as half of this increased deficit could be reduced with more realistic values of the dollar. The second group is essentially the Far Eastern countries, for which the deficit totalls $61 billion, up from $25 billion three years ago. If the dollar were to remain at its current level, that deficit would probably increase about $10 billion per year indefinitely. If the dollar were to decline by 20%, range, we think the Far East deficit could be held at its current level but doubt that it would be diminished significantly. The third group consists primarily of Third World nations; we have also included OPEC in this category. The U. S. does not have a particularly large deficit with this group at present, as it totals some $34 billion, but only three years ago these countries accounted for a surplus of $14 billion, so the annual swing has been about -$16 billion per year. As mentioned above, this deficit is relatively insensitive to relative prices, so it is likely to continue to expand at about $10 billion per year indefinitely. That suggests that if the dollar remains near current levels, the trade deficit will increase $20 billion per year; and that even if the dollar were to fall as much as 20% the deficit would not improve at all. In other words, even with a sharply reduced value of the dollar, we would not look for any improvement in our merchandise trade balance in the foreseeable future except under conditions of a significant downturn in overall economic activity.

Table 4 indicates where the greatest erosion has occured in our trade balance by various commodity classifications. While the deficit in fuels is obviously very large, it has not changed materially since mid-1982 — but that is the only major category for which that statement holds. Our traditional surplus in agriculture has been badly battered, falling from $12 billion three yeras ago to -$3 billion currently; even those who like French wine and cheese can admit it is ridiculous for the U. S. to be a net importer of agricultural products. Our advantage in exporting crude materials excluding fuel and chemicals has been cut in half, although these two categories are still in surplus. However, this is more than offset by almost a $20 billion decline in net exports of what the Commerce Department calls "manufactured goods" but is actually semi-finished goods. The biggest gain in imports in this category has been the increase in parts — the analog to the loss of jobs in the fabricated metal products industry.

The biggest overall decline has occurred in the machinery and equipment category; since this covers a multitude of sins, we have attempted to break it down into its principal components. The coverage between mid-1982 and mid-1985 is not identical even though we are working with the same Commerce Department release, so the comparison for computers, semiconductors, and what is called telecommunications equipment (although that also includes radios, TVs, and hi-fi equipment) are estimated rather than exact. Nonetheless, the figures are accurate enough to document the major swings that have taken place since mid-1982. Except for holding our own in aircraft, the rest of the table looks like a minefield. The $20 billion worsening of our deficit in motor vehicles and parts does not come as much of a surprise, but the declines in electrical machinery, semiconductors, computers, and other electronic equipment, where we are supposed to have state-of-the-art technology and management, are not at all comforting. Furthermore, the recent layoffs in Silicon Valley and its clones around the country do not augur well for future developments in these areas, as the Far Eastern nations start to take increasingly deadly aim at our high-techonology sector.

The mass of gloomy numbers in this section and their implications for the overall forecast can be summarized as follows:

1. The transfer of jobs overseas is permanent, and actually started in advance of the strengthing of the dollar because of the lack of a cost-competitive structure in this economy in the late 1970's. Once gone, these facilities will not return. Furthermore, the success of these overseas facilities means that a disproportionate amount of expansion in manufacturing capacity will continue to occur outside this country.

2. Only about one-third of the decline in net exports since 1982 can be directly related to the overvalued dollar. The biggest swing in the net trade balance has occurred with the Third World nations, who face institutional constraints that require they export more and import less to this country.

3. The erosion of trade has occurred not only in our basic industries that lack the capital and management skill to institute the most modern techonology, but also in the high-tech sector where it had been thought the U. S. would retain its lead indefinitely.

As a result of all these factors, our net trade deficit has moved to a position where it is not particularly price sensitive any more. It still is income-sensitive; a rip-roaring recession would temporarily reduce our trade deficit, but is hardly worth the price. Attempts to push the dollar lower, either with easy monetary policy or by jawboning, will have little effect on our foreign balance even if such methods were to be successful. The drumbeat of continuing decline in net exports will continue at least until the end of 1986.

Thus the underlying problems of sluggish productivity growth and the potential for higher inflation remain unabated, even though prices have risen very little during the previous year. We attribute that to the mid-cycle pause from which the economy is now just emerging as much as the strong dollar, which we think will not do nearly as good a job of keeping the lid of prices once real growth returns to the 4% to 5% range. In the concluding part of this month's ANALYSIS, we now examine why inflation is likely to rise at least 2% over the next two to three quarters, bringing with it higher interest rates and an eventual recession late in 1986 or early 1987.

A REPORT CARD ON THE U.S. ECONOMY

THURSDAY, OCTOBER 17, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2220, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Chairman LaFalce; Representatives Lundine, Vento, Carper, and McCandless.

Chairman LaFalce. The Subcommittee on Economic Stabilization will come to order.

Our subcommittee is very pleased to have with us this morning Prof. Walter Heller of the University of Minnesota. Professor Heller was Chairman of the Council of Economic Advisers under President Kennedy. He was the architect of the 1963 tax cut, which is widely credited with spurring the economic boom that continued for the remainder of the 1960's.

Professor Heller takes issue with those who have likened the 1963 tax cuts to the recent 1981 cuts. Among other distinctions, he has argued that the 1981 cuts were both excessively deep and regressive.

In the last few days, he has written his semiannual review of the economy and its outlook. The forecasts of other economists go from 0 to 5 percent real growth in the near term.

We look forward to hearing Professor Heller's forecast and evaluation of the major risks for that forecast.

Several of our witnesses in recent months have emphasized the importance of lowering the dollar to restore the health of industry and agriculture. A couple of days ago, however, Federal Reserve Chairman Volcker reminded us that a rapidly declining dollar could reignite inflation. Our witness has also been looking into this vexing tradeoff between production and inflation.

To his credit, Professor Heller is not interested solely with the big picture in macroeconomic terms. He has consistently shown great concern for the equitable distribution of our Nation's fruits.

Thus, it is not surprising that Professor Heller has been speaking out against the risks of the so-called Gramm-Rudman amendment. He finds the proposal wrong headed not just on grounds of equity, but for its potential costs to the overall economy and our military preparedness.

I understand that Professor Heller has taught 70,000 students in his 50 years of teaching economics. Perhaps that helps explain why the electorate of Minnesota tends to vote somewhat differently from much of the rest of the country.

At this hearing, Professor Heller will review the record of the economy since the 1981 departures in tax and budget policies. He will also discuss the consequences for growth, stability, and equity of adopting alternative macroeconomic policies.

At this point I will insert in the record the opening statement of the ranking minority member, the Honorable Norman D. Shumway.

[The opening statement of Mr. Shumway follows:]

Statement of the Honorable Norman D. Shumway
October 17, 1985

Thank you, Mr. Chairman. Mr. Heller, it is a pleasure to have you here today to summarize for the Subcommittee where the country stands in terms of economic conditions. More importantly, your overview should assist us as to what to expect from the policies that have been pursued thus far.

From my perspective, I think we can be optimistic about the 1985 economic report card. True, from mid-1984 until now, the American economy has shown only modest growth. During this period, interest rates declined; the U.S. dollar strengthened; the trade deficit increased; Americans lost jobs due to imports; and major industries felt the impact of squeezed profit margins. Needless to say, it was not a good time for the American economy.

However, statistics for the third quarter of 1985 are, in my view, the harbinger of a robust and growing economy. Last month, the Department of Labor announced that the August unemployment rate fell to a five-year low of 6.9%. Inflation remains consistently in the 4% range. Interest rates have fallen sharply. The U.S. economy, fueled by this Administration's tax cuts and record levels of investment -- much of it in the form of dollars returning to the U.S. from their short trip abroad to pay for America's import surplus -- created 9 million net new jobs in five years. And today, the Department of Commerce will announce that our economic growth has increased well beyond earlier predictions.

In the midst of this prosperity, however, voices of alarm are beginning to sound from several quarters. Admittedly, the slowdown of the part twelve months has made many observers concerned about the potential for recession, with its accompanying ill effects on employment and inflation. However, the focus right now has shifted to the magnitude of the foreign trade deficit, the inability of U.S. companies to compete against foreign subsidized industries, and the subsequent loss of American jobs. Indeed, we now see a new economic force at work: protectionism.

Whether cloaked in such mystical terms as "fair trade" or "level playing field" or not, protectionism is not the answer. This is not to say that there are very real problems in our economy. Some industries and firms are losing their ability to compete in the world market, causing great hardship to some working families. Some exporters are facing illegitimate barriers to the export of their goods and services. Congress is right to wish to help change the situation.

One way to address the problem is for Congress to make a meaningful reduction of the federal deficit. I am sure there are other measures; however, addressing the budget deficit is within our immediate means and should be our immediate priority.

Chairman **LaFalce**. Professor Heller, it is an honor for us to have you with us today. Let me ask that you proceed in any manner you wish to.

STATEMENT OF WALTER W. HELLER, REGENTS' PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA

Mr. **Heller**. Thank you very much, Mr. Chairman.

You have given me sort of a tall order, and it seems to me that inviting me to evaluate macroeconomic policies in recent years in terms of equity, growth and stability, you are really in effect requesting a report card on Reaganomics. While I cannot provide a comprehensive appraisal of President Reagan's macroeconomic policies in the brief compass of this statement, I will try to highlight a few of the key impacts of the Reagan policies to date, and the directions in which they are leading us.

I will start with the equity of economic policies, and focus in particular on what has happened to the incidence of poverty and the distribution of income in the United States.

The facts here are very clear, but unfortunately, Mr. Reagan labors under a misconception that is directly contrary to the facts.

Some time ago, he said,

> In the early sixties, we had fewer people living below the poverty line than we had in the later 1960's after the great war on poverty got underway. And there has been from that moment on a steady increase in the level of poverty.

What are the established facts? They are exactly contrary to what the President said. The percentage of the population in poverty in 1959 was 22 percent, but the combination of steady growth in the 1960's coupled with the war on poverty cut this in half by 1969, to 11 percent of the population.

The poverty rate then rose modestly during the slow growth of the 1970's, reaching 12 percent in 1979. From 1979 to 1983, it rose by over one-fourth, reaching 15.3 percent in 1983.

Under the impact of recovery, it declined to 14.4 percent in 1984. Still leaving aside the Reagan years, this is the highest rate since 1966. This translates into 33.7 million people living below the poverty line, $10,609 in annual cash income for a family of four.

One should note in passing that the official poverty rates, which I have been quoting, do not include noncash benefits such as Medicaid, Medicare, food stamps, subsidized housing, and school lunches.

The Census Bureau estimates that if all these benefits were included, the poverty rate would be 9.7 percent in 1984 if the noncash benefits are counted at market value or 12.2 percent if they are counted at less-than-market value because of the lack of freedom of choice.

Chairman **LaFalce**. Are you going to comment on that?

Mr. **Heller**. The official Census Bureau poverty rate is 14.4. Plugging in these noncash benefits, it is 9.7, but a lot of economists feel they shouldn't evaluate those at market value, actually they are not worth the market rate, you can take your pick. It was 11 in 1969 and on an absolutely comparable basis, it is 14.4 today.

Chairman **LaFalce**. If we do a little more refinement, we are going to come up with either 9.7 or 12.2, depending on how we wish to count the noncash benefits, but could we compare that with some figure that includes noncash benefits in either 1969 or 1980?

Mr. HELLER. Yes, well, that is quite a fair question, and I have the answer deep in my papers here. Let me give a rough approximation from memory. It would have been in 1969, of course, noncash benefits were not quite as large a proportion then; but that might have reduced to about 8 percent at that time, and in 1980, as against the 9.7 now, it was about 6.5, so from 1980 to 1984——

Chairman LAFALCE. A 50-percent increase?

Mr. HELLER. You did go up from about 6.5 to 8.7.

Chairman LAFALCE. It is very important to pin that down, so I would ask you to give us the comparative figures, both with respect to 1969 and with respect to 1980, if you have them.

Mr. HELLER. All right, there are so many points to cover that I decided not to put that in, but I will be happy to do so.

Chairman LAFALCE. I want to make sure we are comparing apples and apples.

Mr. HELLER. The apples and apples is the 11 and the 14.4, as far as this is concerned—some sources say 1969 was 12 percent, others, 11 percent; there is no dispute about the 14.4 percent. The others I have given you an approximation.

[In response to the request of Chairman LaFalce, the following information was submitted by Mr. Heller:]

The percentage of the population below this poverty level, adjusted for in-kind transfers—at market value—was 6.1 percent in 1979, 8.8 percent in 1982, and 9.7 percent in 1984. See Brookings Institution: Economic Choices, 1984, p. 161 for 1979 and 1982 numbers.

Chairman LAFALCE. Please proceed.

Mr. HELLER. Turning to the distribution of income, we find that the shares of total money income received by families at different income levels remained remarkably stable throughout the postwar period.

For example, the 20 percent of families at the bottom of the income scale received about 4.5 percent of total money income in 1947, and about 5 percent in 1980, while the top 20 percent received about 42 percent in both years.

The reduction in poverty was made possible by economic growth, which lifted all the boats, and by Government transfers.

Since 1980, for the first time in the postwar period, the distribution of income has worsened. In 1984, the poorest 40 percent of all families got 15.7 percent of all income, the lowest share on record, while the share of the top fifth rose to nearly 43 percent, the highest share since 1948.

I don't think President Reagan set an upward redistribution of income as his objective, but it is the natural fallout from his policies. If you cut the taxes of the upper income groups and cut the benefits of the lower income groups, it is inevitable what is going to happen.

Chairman LAFALCE. What is the source of your statistics—40 percent of the families got 15.7? I wonder if we could have the 1984 figures.

Mr. HELLER. I would have put in the 1984 figures, if I had had them. In this case, I believe we can get them from that source that I am quoting there.

[In response to the request of Chairman LaFalce, the following information was submitted for the record by Mr. Heller:]

The Center for Budget and Policy Priorities, Washington, DC.

Mr. **Heller**. Of course, the severe recession and unemployment of the 1980's clearly had something to do with these numbers. But as the objective studies of the Congressional Budget Office, the Urban Institute and other groups have shown, the combination of the Reagan budget cuts and tax cuts has cut the incomes of the poor and increased the incomes of the wealthy.

[The following supplemental information was received from Mr. Heller for inclusion in the record:]

The Urban Institute study, "The Reagan Record," concluded that cuts in welfare and social insurance under President Reagan accounted for more than a third of the increase in poverty—see chapter by D. Lee Bowden and John L. Palmer.

Mr. **Heller**. Some people have called it comforting the comfortable and impoverishing the poor, and that is what it has added up to statistically.

One hopes that Mr. Reagan will recognize these facts about poverty and income distribution. At stake is his low opinion—indeed, his ridicule—of antipoverty efforts by the Government, and his evident willingness to train most of the fire power of this deficit-cutting efforts on social programs that particularly benefit lower-income groups.

This has been amply demonstrated by his recommended budget cuts so far and would be carried much further under the Gramm-Rudman bill that he has enthusiastically endorsed.

It is one thing if the President is under a misconception about this or that number, and it does not affect policy, but when the President of the United States honestly believes that the war on poverty increased poverty, that is directly contrary to the facts. When he believes that there has been a steady rise in poverty from 1965 to 1985 and sort of saying "the increase under my administration is part of a general trend," those are simply manufactured facts.

I am sure he believes it and that is what is so dangerous, because on the basis of those facts, he makes his policy declarations and conclusions.

Chairman **LaFalce**. It is what he knows that is not true that disturbs us.

Mr. **Heller**. At the same time, one should acknowledge that the Reagan tax reform proposals include a doubling of the personal exemption and increases in the standard deduction that would take almost all of the families now in poverty off of the income tax rolls.

One of the amazing things is that we now are taxing people in poverty at a fairly good clip, around $10,000 of income. Whatever else is done or not done in the course of tax reform, one would surely hope that this move would survive.

One should note in this connection that if the income tax exemption were converted from a deduction from income into a credit against tax, the lowest income groups could be fully protected with a much smaller loss in revenue.

The political problem is that in converting the exemption into a tax credit, even if the value were doubled for the lowest income brackets, upper middle and higher income groups would actually experience a reduction in the tax value of their exemption.

I tried this out on Secretary Baker a few months ago, and asked him whether he considered converting it into a tax credit and he said he had never heard of the idea. I think he has heard of it since, and that is something the Congress should consider.

Some of us have been trying to get somewhere with this idea for 25 years. It is a way of protecting the lowest income groups and not give the upper income groups the exception of the——

Chairman **LaFalce**. The increase in the standard deduction—while the President is not calling for the converse, you have to query whether the tax cuts of 1981 will enable us to do now what should be done.

Mr. **Heller**. That is a distinct question and problem.

But beyond the adjustment of the income tax, if I perceive the thrust of the President's approach correctly, his answers to the damning numbers I have just reviewed would be,

> Give us time. Our policies will boost savings and investment, thereby increase the supply capacity, productivity and growth rate of the U.S. economy and generate jobs. All this will lift the poor out of poverty.

Clearly, in spite of last year's improvement, we have lost ground on poverty and income distribution in the 1980's. What about jobs? Unemployment, after rising to record postwar levels in 1982, dropped sharply in 1983–84.

But it has been stuck at about 7¼ percent for a full year, sharply above the 5.8-percent rate in 1979, before the recession started.

The modest rate of economic recovery in the past year has not only failed to reduce the official unemployment rate, but has led to an increase in the category of "discouraged workers," now numbering 1.231 million, and made only a small dent in the number of part-time workers who would like full-time jobs, now number 5.551 million.

If you add to the roughly 8 million officially unemployed, the 1.23 million discouraged workers and the 5.5 million workers who would like to have a full-time job, the unemployment problem is still huge.

In response to these discouraging members, Reagan administration supporters point out that 9 million new jobs have been created since 1981, and that the United States experience is in bright contrast with the experience in Western Europe, where unemployment averages near 11 percent of the labor force.

But to put this 9 million gain in perspective, one should note that the administration argued in 1981 that its programs would create 12 million new jobs by 1986, 3 million more than if nothing was done.

In other words, employment growth is achieving only the base line level that the administration projected would exist in the absence of its programs.

Chairman **LaFalce**. Are you saying that the administration argued in 1981 that we would have only 9 million new jobs by 1986 if we did nothing, and, therefore, since we needed more than 9 million new jobs, we ought to adopt some policies and create 3 million new jobs above and beyond what was already projected?

Mr. **Heller**. Exactly, and you go back to what they proposed in 1981, and that is where you find these projections. What I am saying is we shouldn't let the 9 million new jobs argument blind us to the huge residue of unemployment that we still suffer from.

Chairman **LaFalce**. Can you give me your documentation for the 9 million base line figure?

Mr. **Heller**. That is going to be difficult.

Chairman **LaFalce**. An economic report to the President, or OMB?

Mr. **Heller**. Later on page 4, I refer to the Barry Bosworth statement, and this is not the original source, but I have never known Barry Bosworth to be wrong on his numbers. The 9 million number and the 12 million projection were in Barry Bosworth's statement before the Joint Economic Committee on September 17.

One should always go back to the original source.

[In response to the request of Chairman LaFalce, the following information was submitted for the record by Mr. Heller:]

That source is the White House 1981 publication, "America's New Beginning", Part I, Progress of Economic Recovery, Page 1, together with projections for 1986 in the President's Budget for fiscal year 1986.

I recall these projections and I am sure I could find them. It would take me a lot longer than it would take him.

In short, we should not let the "9 million new jobs" argument blind us to the huge residue of unemployment we still suffer from, nor the fact that we are falling grievously short of the targets the administration set for itself in 1981.

That leads us into the even thornier thickets of the Reagan savings and investment policies. For, presumably, if the tax and other policies of the 1980's were generating a strong surge of investment in plant and equipment, research and development, and technological advance, the payoff in more and better jobs and higher living standards would not be too far off.

All you have to do is listen to the false claims of the supply-siders, who claim there has been a tremendous investment boom and so forth. Let's take a look at that.

The evidence gives no aid and comfort to this hopeful view. Yes, we had a big spurt of business-fixed investment in 1983 and 1984. But now, not only has that fizzled in 1985, but analysis shows that our savings and investment record of the 1980's has been the poorest in some 50 years, since the thirties.

The tax stimulants to saving and investment have been simply overwhelmed by the ravenous appetite of the U.S. Treasury for over half of net domestic savings needed to finance its deficits, its dissaving.

Here, as I note, I am drawing heavily on Bosworth's statement.

It is true that the monstrous 1981 tax cut gave a powerful demand-side thrust to the economy that lifted us out of the 1980–82 recession. But as a stimulus to supply, it has thus far been a failure.

Largely through the mountainous Federal deficit, the Reagan program produced a pattern of national saving and investment that has undercut, reduced rather than increased, the long-term growth rate of the U.S. economy.

Instead of an investment boom, we have been on a consumer binge financed by the liquidation of our assets abroad. We have become a debtor nation because we have incurred more foreign debts than we have foreign assets, and it was financed by the skyrocketing import surplus, and by the lowest rate of national savings and investment since the 1930's.

If this sounds shocking and implausible, one needs only to look at the facts to substantiate the foregoing conclusion:

The tax cut did not budge the net longrun private savings rate of about 8 to 9 percent of GNP. That is individual plus business saving minus replacement investment.

The gargantuan Government deficit, or public dissaving, offset half of that. That is, half of all private saving had to be used to finance the budget deficit, with the result that the national saving rate fell from 8 percent to just over 4 percent last year.

In other words, we distinguish between the consumer saving rate, the private saving rate, and then the national saving rate which takes the Government dissaving rate into account.

To be sure, net investment stayed at about 7 percent of GNP, but that was made possible only by sucking in huge amounts of foreign saving. Net investments by Americans is at its lowest ebb since the 1930's.

That is directly contrary to the impression that the administration has tried to create, and that some economists, especially the small remaining band of supply-siders are trying to perpetrate on us.

With respect to the inflows of capital from abroad, none of us can be certain that those flows will continue at a clip of $100 to $130 billion a year. If that stream were suddenly to dwindle, it would boost U.S. interest rates and severely impact capital formation and housing.

But letting it go undiminished means that our external debt would reach $800 billion by 1990. That is a modest forecast compared with the numbers of Fred Bergsten, he has a trillion, but I am a pretty conservative fellow, so I just put in $800 billion.

At an average 10-percent rate of interest, that means an $80 billion annual bill for interest and dividend payments to foreigners, a bill that could only be paid by shipping out goods and services at the expense of the American standard of living in 1990 and beyond.

But, critics may ask, what about that 1983–84 surge in investment spending? Doesn't that show that the tax cut worked and the investment picture is healthier than I have just implied?

Taking a closer look at that boom, one finds that 93 percent of the increase in equipment spending since 1979 is accounted for by office equipment, mainly computers, and business purchases of autos, including small trucks.

It is interesting to note that neither of these categories enjoyed a net cut in tax rates under the 1981 and subsequent tax acts. 10–5–3 didn't do anything for computers and automobiles or small trucks.

Overall, it did not decrease the effective tax rate on business automobiles. That is something that can be documented.

[The following supplemental information was submitted for the record by Mr. Heller:]

I erred in including small trucks. My statement is correct for the category "business automobiles" which, when the replacement of the prior accelerated depreciation provisions by the fixed 3-year acceleration provision in the 1981 law is taken into account, received little or no tax benefit from that law. Still business purchases of autos surged. Ironically, sales of "trucks and busses," which got a tax break, grew abnormally slowly.

Mr. **Heller**. The related point is that investment in American industrial capital has been steadily declining as a share of GNP. The benign impact of tax incentives has been swamped by the malignant impact of sky-high real interest rates, which in turn trace back in large part of the huge Federal deficit.

When you look at the cost of capital, which is what you have to look at when you are talking about stimulus to investment, the tax incentives have been swamped by the high real interest rates.

Before turning to the deficit, perhaps we should ask: Won't tax reform restore the incentive for capital formation? Part of the answer is obvious: We don't know, since we at this point don't know either the ultimate fate or the contours of tax reform.

But beyond this, I think economists should admit that the tax system is so complex and has such a multitude of special provisions that we can no longer tell you for sure whether a particular tax provision will in fact promote or discourage capital formation.

What an economist can tell you is that cutting the Federal deficit will increase national saving and private investment. Even here, one has to add, "provided that the cut in the deficit does not result in slowing down the economy as a whole through a reduction in demand."

From the foregoing analysis, one can see that the massive deficits created by the largest tax cut in history, coupled with the biggest peacetime defense buildup in history, are defeating the very essence of Reaganomics by curbing the savings flow and thwarting the President's investment and growth objectives.

Both by undercutting the rate of capital formation and by building up a huge foreign debt, these policies are also leaving a lean and bitter legacy for future generations that will have to do with a small capital base and a large liability for overseas debt service.

Rudy Penner, the highly respected head of the Congressional Budget Office, calls it fiscal child abuse. I think that is an appropriate and effective term.

In this light, it seems strange that Mr. Reagan is so adamant in barring tax increases as part of the deficit-reducing package. Perhaps one has to go beyond crass antitax politics and economic analysis to psychoanalysis to understand his position.

Deep down, the President must be clinging to the conviction, contrary to virtually all the evidence, that holding firm on the tax front helps squeeze down Government spending, especially on social programs, in response to the excruciating pressures of the deficits.

Senator Durenberger of Minnesota—I always quote people from my State whenever possible—said that he is about to subscribe to the theory that "there is some deliberate intention to use deficits to get us to denationalize the financing of public services."

Ironically, it turns out that the huge Reagan tax cut, coupled with the big military buildup, is itself the greatest single source of nondefense spending increases through its impact on the public debt and interest rates.

Net interest on the public debt has zoomed from $43 billion in 1980 to a projected $138 billion in 1986, and, at the present rate of increase, would reach over $200 billion in 1991.

What I am saying is that the weapon, namely huge deficits, used by Mr. Reagan to try to squeeze social and civilian spending is itself the greatest single source of increased nonmilitary spending through the interest rates.

If Senator Durenberger is on the right track in his assessment, it may explain why President Reagan has so enthusiastically embraced the Gramm-Rudman proposal for ending the deficit by a series of lock-step budget cuts.

Since I testified on this proposal before the Joint Economic Committee last Friday and dealt with it in a commentary last evening on the Nightly Business Report on PBS, I would like, if I may, to offer these statements for the record. I will add only a few comments here.

I have made available those two statements to your staff, Mr. Chairman. I would like to enter those in the record.

Chairman LaFalce. Without objection, so ordered.

[The statements referred to by Mr. Heller follow:]

DOWN THE GARDEN PATH WITH GRAMM-RUDMAN

Script for the
"Nightly Business Report," PBS
October 16, 1985

by
Walter W. Heller
University of Minnesota

Gramm-Rudman seems to be the name of the game in Washington this week -- and a dicey game it is.

Clearly, Congress wants to cut the deficit in the worst way -- and the Gramm-Rudman bill passed by the Senate does just that. It embodies a lock-step formula to eliminate the deficit in six years, a formula that is economically disruptive, socially unfair, militarily dangerous, technically inept, and politically irresponsible:

- It would disrupt the economy and invite recessions by forcing huge spending cuts even in the face of slow growth and high unemployment. It has a weak-kneed escape clause that offers little protection on this score.
- It would focus its civilian spending cuts primarily on the social programs for the poor that have already been so hard hit.
- It would require sharp cuts in defense, primarily in our readiness forces, a nice exercise in unilateral disarmament.
- It is full of flaws, especially in drawing irrational lines between what it calls "controllable" and "uncontrollable" expenditures.
- It is, as even co-author Rudman admits, "a substitute for guts." It sidesteps tax increases, puts social security off limits, relies on across-the-board spending cuts for which no one can be held accountable, delays any cuts until after the 1986 election, and tosses big chunks of Congressional power to the White House. Someone has called it an exercise in self-esmasculation.

One can sympathize with the desire of Congress to cast off its image, unfair though it is, of failing to face up to the deficit. Yet, the irony is that if Congress had not taken the lead in 1982, and again in 1983 and 1984, to cut spending and boost taxes, our deficit would be running $100 billion-a-year higher.

Yet, here it is, engaged in a pell-mell rush to enact something that gives the appearance of self-discipline, but is really just a substitute of procedure for will. One has to hope that Congress, at the very least, will give itself time to change a rigid and Draconian formula into one that is flexible but still Spartan. Or have we really passed the point of no return to rationality and responsibility in coping with our monstrous federal deficit?

STATEMENT ON BUDGET BALANCING
BEFORE THE JOINT ECONOMIC COMMITTEE, U.S. CONGRESS

by

Walter W. Heller
Regents' Professor of Economics, University of Minnesota
Washington, D.C., October 11, 1985, 10:00 a.m.

Mr. Chairman and Members of the Committee:

I appreciate this opportunity to present my views to the Joint Economic Committee on the Gramm-Rudman-Hollings bill which is designed to bring our dangerous federal deficits under control.

Clearly, Congress wants to tame the deficit in the worst way -- and the Senate bill comes close to doing just that. As it stands, it is an economically disruptive, socially unfair, technically deficient, and politically timid formula for deficit cutting.

Politically timid? Senator Rudman himself puts it more bluntly: "Lowell Weicker says this is a substitute for guts, and I agree with him." The truly tough ingredients of a balanced attack on the deficit -- tax increases and social security curbs -- are held harmless under the misshapen structure of the Senate bill. And on defense, if I read it correctly, combat readiness will take a solid hit while the weapons systems that sometimes serve as a defense pork barrel bill probably go unscathed. What about vital social programs for citizens with the least political clout? It's "hit 'em again, harder."

Further, while Gramm-Rudman barks loudly at our damaging deficits, it won't really bite until the Congress is safely past the 1986 election. In a sense, the worst cop-out of all is the bill's provision for across-the-board cuts without regard to need, merit, or quality of the program, and without having to face tne music for such cuts -- it is a "See Mom, no hands" or "Who, me?" approach. So much for the politics of the matter.

Now, what about the economics of it? Like any mandated and rigid formula, it would undermine, perhaps even pervert, the role of the Federal budget as an economic balance wheel in the economy.

Rigid reductions of the deficit through thick and thin -- through recovery and recession -- could wreak havoc on the economy. Granted, the Senate bill has a weak-kneed provision to give the President an extra thirty days to decide where to cut the budget or to call for suspending the amendment if the CBO (Congressional Budget Office) and OMB (Office of Management and Budget) predict a decline in real GNP for two successive quarters. There are three fatal flaws in this formula.

First, economic forecasting, and particularly government economic forecasting, has had a poor record in predicting recessions-to-come, and indeed, has at times failed to "foresee" a recession that was already underway. (And by the way, forcing the CBO and OMB to come up with a single set of economic and budget projections -- or splitting the difference between the two if they can't agree -- looks like a sure-fire way to politicize the economic projection process.)

Second, as the economy moves from recession to recovery, it can produce increases in GNP even while operating far below par. Suppose a recession reduced GNP in 1987, but modest recovery raised GNP in 1988. The Gramm-Rudman process would require that the budget deficit be only $108 billion in fiscal 1988 even if the $144 billion target for fiscal 1987 had been suspended because of a projected drop in GNP. It would be damaging enough to have to put in a $36 billion or $72 billion deficit cut in 1988, but the cut would in fact have to be much greater. Looking at the CBO numbers (published in August) for a scenario of a recession in 1987, with an average recovery performance in 1988, one finds that they project a $270 billion deficit in 1988. Imagine the economic setback it would cause to slash spending and the deficit by $160 billion by 1988 to try to reach the $108 billion deficit level fixed by the Gramm-Rudman formula.

I say "try" because the facts are that it couldn't be done. If the national economy starts to slide, joblessness rises, income and profits fall, and the federal budget automatically goes into deficit as revenues shrink and spending rises. Try to balance it by boosting taxes or forcing cuts in spending, and the net result will inevitably be to draw that much more purchasing power out of an already soft and sluggish economy. This would send the economy into a deeper tailspin, thereby throwing more people out of work, further cutting tax revenues, and boosting unemployment compensation, food stamps, and similar entitlement expenditures, thus throwing the budget even more out of whack. A dog chasing its own tail comes to mind.

Third, consider the situation where there is no actual drop in GNP but a continuing "growth recession', namely, where the growth rate falls below the level required to maintain or reduce the unemployment rate. More spefically, suppose you had two years of very slow growth. Let's say that GNP growth for two years would fall two percent short of the growth rate needed to reach the projected high-employment level of about $5 trillion a year. That's a GNP shortfall of about $300 billion (two percent in year 1 and four percent in year 2). About 20 percent of that shortfall will be reflected in lower government revenues, producing a $60 billion added deficit. Yet, the Gramm-Rudman formula would rigidly require that this $60 billion be made up in addition to the $72 billion cut under their formula. Again, that would simply kick the economy in the groin and bring on an actual recession.

In failing to distinguish between deficits caused by economic recession and slow growth from deficits caused by tax and spending policies -- that is, failing to take account of the basic difference between the cyclical and structural components of the deficit -- the Gramm-Rudman plan takes us back to the Dark Ages of budget thinking and practice.

The technical problems of the Senate bill (unless it is modified after I write this on October 10) are legion, especially with respect to the definition of "controllables" and "uncontrollables." Let me cite a couple of examples.

Spending out of prior years' contracts is considered uncontrollable and would therefore escape the budget axe. Note what that would do in the defense area: almost 100 percent of procurement, largely weapons systems, is under prior-year contracts, hence "uncontrollable." In sharp contrast, one finds that 55 percent of research and development is under current contracts and hence "controllable;" 85 percent of maintenance and operating expenditure is current: and well over 90 percent of personnel expenditures are current. So the military share of the budget cuts would be heavily concentrated on military readiness expenditures.

Now, suppose that even the defense expenditures under past contracts were defined as "controllable." Then, to bear their across-the-board percentage share of the burden, practically all current expenditures on past contracts would have to be wiped out. Rigid formulas are obviously the enemy of rationality.

In the civilian budget, one finds that items like national parks would be hit very heavily because very little of their expenditure is under prior contracts. On the other hand, hospital construction, under long term contracts, would hardly be hit at all. Or to take another example, 80 percent of Peace Corps expenditures would be labeled "controllable," but only 33 percent of Export-Import bank expenditures would be subject to the budget knife. Enough said. Capricious cuts would be the name of the game.

These examples relate directly to another critical issue, namely, that of the distribution of the cuts among entitlements, non-entitlement social programs, and the military. With interest on the public debt, social security, and prior-year contracts (covering about 40% of military expenditures) all off limits, one-third of the budget would have to take the brunt of the supposedly "across-the-board" cuts. That is, the "controllables" would be less than $300 billion out of a roughly $95C billion budget in the current fiscal year. Two-thirds of that is defense. The remainder, under $100 billion, would be the focus of the hardest hits. After taking care of non-social-security indexing adjustments, the rest of the impact would have to be borne by social programs. The cuts could be savage, whether administered by the President or by Congress.

I have long believed -- and publicly documented and defended the position -- that the Congress has been the more responsible end of Pennsylvania Avenue in coping with and cutting the deficit. That judgment is fully confirmed by the in-depth studies of Norman Ornstein, Resident Scholar of the American Enterprise Institute. A few excerpts from his chapter on "The Politics of the Deficit" (in AEI's Contemporary Economic Problems, 1985) will make my point:

- In 1982: "It was Congress, in an approximation of congressional government that defied conventional wisdom in an election year by slowing defense and raising taxes to reduce the deficit."
- "In 1983, Congress initiated an energy tax increase. In 1984 the Republican Senate once again moved into a policy vacuum, proposing a 'down payment' on the deficit, including another significant tax increase, which the President once again belatedly endorsed."
- "Through the broad sweep of American history, Congress has struggled to restrain the growth of federal spending and to limit deficits and the public debt through direct action and through periodic adjustments of its own structures to minimize the deleterious effects of political pressures."

Even the Gramm-Rudman initiative, flawed as it is, came from the Congress and gained the President's support only after a period of White House hemming and hawing.

And contrary to the view of the cynics who airily dismiss the budget-and-deficit-cutting exercises now going on in the appropriations committees, those committees are conscientiously going through a painful process to carry out the sizable deficit cuts in the Congressional Budget Resolution of last August. Even if one lets the air out of some of the inflated estimates of deficit-cutting in that effort, it appears that meaningful deficit reductions will emerge from this process.

I understand the frustration of a Congress, not normally meant to be an instrument of national leadership, being constantly forced to take the lead in budget-and-deficit cutting to fill the policy vacuum left by the President. And all the while, the Congress is being berated and ridiculed by a popular President who turns reality upside down and pretty much persuades the public that Congress is the culprit, that Congress is responsible for his $200 billion deficits and $2 trillion debt.

Under these trying circumstances, and given the dangers of our obscene federal deficits, it is not surprising that the Congress is drawn off course by the siren song of Gramm-Rudman. But instead of joining a pell-mell rush to fasten on yourselves a budgetary straight-jacket and a lock-step deficit-cutting schedule, at the same time slicing off big chunks of your fiscal power and handing them to the President, let me urge you to stop, look, and listen. The Congress should demand time to develop a fair and workable schedule for cutting the deficit without disrupting the economy and gutting social programs and then go to the American people with that plan to subdue the deficit.

Is the Gramm-Rudman formula so flawed as to be beyond redemption? Can one develop a viable substitute that will hold policy-makers' feet to the fire and yet avoid the straight-jacket and cop-out features of the Senate bill? I have my doubts. But if the legislative juggernaut is relentlessly rolling to passage, what do you do to make the cure better than the disease?

The obvious answer is to change the Gramm-Rudman prescription so as to maintain the central principle of progressive reduction of the deficit but remove the dangerous side effects of that prescription. How? Perhaps start with the Democratic alternative in the Senate and tighten it as follows:

- Provide sensible safeguards on the economic front by changing the unworkable anti-recession provisions of the Senate Bill, relating them not to forecasts of two quarters of real GNP decline but rather to some reasonable growth rate of GNP and, preferably, to the rate of unemployment.

- Open the budget-reduction process clearly and candidly to revenue increases, perhaps even providing for triggered tax increases under specified conditions -- a standby surcharge on corporate and individual income taxes would be one simple way to go.

- Remove the absolute prohibition of any modification of Social Security indexing.

- Remove the formula rigidities that now focus the firepower of deficit-cutting on the social programs that have already been hit so hard.

- Finally, correct the technical anomalies in the Senate bill relating to the definition of "controllables" and "uncontrollables" that would have such a distorting effect on the allocation of cuts between military and civilian programs and within the defense budget itself.

In other words, change a rigid and Draconian formula into a flexible but still Spartan one. It's a tall order. But I sincerely hope that we have not passed the point of no return to rationality in coping with our monstrous budget deficit.

Mr. HELLER. The Gramm-Rudman formula is basically flawed in making no distinction between constructive deficits that can help the economy climb out of recession or overcome slow growth, and destructive deficits that boost interest rates and undermine savings, investment, and growth.

I was not a critic of the $200 billion Reagan deficits in 1982, 1983, and 1984, because at that time, they were helping the economy climb out of the worst recession since the Great Depression.

They, at that time, it seems to me, were fairly benign. They have since become malignant. I sometime use movie ratings to describe the progress, they originally had a G rating, then PG, then R, and now they should be rated X, downright obscene.

Now, also, the Gramm-Rudman formula fails to recognize the difference between the cyclical and structural components of deficits. Its weak-kneed provision for temporary suspension of its formula if a drop in GNP is forecast provides very little relief on this score.

Indeed, the Gramm-Rudman plan would send us on a mindless course—and also what even Senator Rudman has admitted is a gutless course—toward budget balance, no matter what economic, social, and military damage it might leave in its wake.

I yield to no one in my concern for bringing our monstrous budget deficit to bay. But unless the rigid and Draconian formula of Gramm-Rudman can somehow be transformed into a flexible but still Spartan plan to bring the deficit under control, I urge Congress not to fasten this ill-fitting straitjacket on itself.

I am not saying that there couldn't be some way to enforce greater deficit cutting discipline on Congress, but Gramm-Rudman is a destructive way to do it.

Let me turn to accentuate the positive for a moment, and turn to the macroeconomic policy scene in Washington.

It is not too late to reverse course and exercise damage control with respect to the Federal deficit. Its impacts are corrosive rather than explosive. It is not too late to shift or even reverse gears on curbing the deficit in a sensible way, coupling spending cuts with revenue increases and perhaps even removing the "off limits" sign from social security.

That is political heresy, and it is easier for me as a professor of economics at Minnesota to say than someone in the Congress.

After all, a liberated David Stockman and an unrepentant Martin Feldstein, both ardent supporters of Mr. Reagan, are urging him to open the doors to a tax increase. Indeed, Mr. Stockman said that what America needs is a good $100 billion tax increase and "that the spending cut episode is over."

And the new Director of OMB, James C. Miller III, sounded admirably flexible in his confirmation hearing when he said that "nothing is off-base, nothing is sacrosanct," went on to say that "some restraint in entitlement programs might well be looked at by the President and Congress," and did not even rule out tax increases as part of a budget package. Hope springs eternal.

Beyond this, we should give credit where credit is due on some of the more recent policy initiatives of the Reagan administration that are both courageous and right headed.

Let me identify and applaud these moves on several fronts and, as you might expect, let me also suggest some additional moves that would help achieve and consolidate the gains promised by these new approaches.

First, the Reagan administration under the leadership of the Baker Treasury, has at long last recognized that, one, in large part, our trade deficit and protectionist pressures trace to a sharply overvalued dollar; and, two, that this country does not have to stand by like a helpless giant, granting what amounts to a subsidy to imports and imposing a penalty on exports.

If the dollar is overvalued by 25 percent, that is the same thing as imposing a penalty on Minnesota farmers, exporters of chemicals, machinery, and so forth.

As a matter of fact, Henry Wallich of the Federal Reserve and a lot of others feel two-thirds of our trade deficit traces to the overvalued dollar rather than any fundamental lack of competitiveness of the American industrial machine, but here again, the job is not done as yet.

The initial success of the big five intervention efforts should now be bulwarked by narrowing the wide gap between our unduly loose fiscal policy and huge deficits and the unduly tight fiscal policies of our trading partners.

Second, the combination of the big five initiative and selective White House concessions on trade has apparently blunted the most dangerous protectionist movement since the 1930's.

Protectiontist legislation will still emerge from Congress, yet President Reagan's moves have apparently gained enough backers in Congress to sustain his promised vetoes.

But the job is not yet done. Now, to keep the protectionist forces at bay and make U.S. producers steadily more competitive, Washington policymakers need to join hands in raising revenues and cutting spending to shrink the deficit, boost savings, and lower interest rates.

Third, with the evident blessing of the President, so far at least, the Federal Reserve has commendably been clearing the path to renewed expansion by running a monetary policy that facilitated a sizable drop in interest rates this year. But its job is not yet done.

To keep expansion going, to bolster fragile financial markets here and abroad, and to facilitate the big five moves to realign the dollar, the Federal Reserve should maintain as easier money policy. Continued economic slack, low inflation, and the declining velocity of money provide a low-risk setting for such an easier money policy.

Fourth, within the past year, bright hopes were kindled for tax reform to reduce the complexity and increase the fairness of the income tax and, above all, to enthrone market advantage rather than tax advantage as a guide to the flow of resources in the U.S. economy.

Base broadening and rate reduction were the watchwords. A great many of us—liberals, conservatives, middle of the roaders—are among economists who have applauded what the Treasury proposed on the grounds that at long last, it would restore the advantage of the incentives of the marketplace rather than the incentives of a distorted tax structure as a guide to where resources should go.

I wrote my first article on that longer ago than I like to remember, 1951, where I proposed that we cut the tax preferences and the loopholes and take out the dividends in the form of lower tax rates or lower deficits.

The promise is a bright one. But hopes for a tough and meaningful reform seem to be ebbing.

A couple of days ago, the Ways and Means Committee took a special break for banks which was supposed to be closed by this tax reform and enlarged it. I am a director of a bank in Minneapolis, and perhaps they will throw me off the board for saying this, but I feel that is the wrong way to reform.

So the job is far from done. Unless the reform process is revitalized, the mountain may labor and bring forth only a mouse.

Finally, even on the budget deficit, some progress has been made. Jousting with an adamant Congress that controls the Pentagon purse strings, the President has broken his lance. The pell-mell defense buildup is being brought within more reasonable bounds.

And Congressional Appropriations Committees are hard at work trying to make a meaningful dent in the nondefense budget for fiscal year 1986 and beyond. But to say that the job is not yet done is to put it very mildly.

I want to add that I hope Rudy Penner and I are not the only people in the country that think the Congress is doing a good job this year. I agree with him. I felt the Congress has been doing a conscientious job of combing through that budget and trying to live up to its budget resolution.

The resolution has a lot of air in it, $56 billion is more likely to be $35 billion, but $35 billion, plus the reductions for future years, is rather substantial, and this idea of chucking all of that and rushing pell-mell into Gramm-Rudman is wrong. After all, Congress, in 1982, under the Dole-Domenici leadership, Congress in 1983 with some energy taxes, Congress again in 1984 took the lead, filled the vacuum left by the White House, and passed meaningful deficit reductions. Here is Congress again conscientiously trying to cut back the deficit, and in effect, the country, I think misled by the President, is saying Congress is irresponsible, so Congress is trying to respond by trying to fasten on itself this straitjacket, saying without it, we are not going to do anything.

I think the Congress is getting a bum wrap. I think Congress has done a lot more than it is given credit for.

[The prepared statement of Mr. Heller, follows:]

A Report Card on Reaganomics: Statement by Walter W. Heller, Regents' Professor of Economics, University of Minnesota

Mr. Chairman: In inviting me to evaluate macro-economic policies in recent years in terms of equity, growth, and stability, you are in effect requesting a report card on Reaganomics. And while I cannot provide a comprehensive appraisal of President Reagan's macro-economic policies in the brief compass of this statement, I will try to highlight a few of the key impacts of the Reagan policies to date and the directions in which they are leading us.

EQUITY

Let me start with the question of equity and focus in particular on what is happening to the incidence of poverty and the distribution of income in the United States. The facts here are very clear, but unfortunately, Mr. Reagan labors under a misconception that is directly contrary to the facts.

Some time ago, he said "in the early '60s, we had fewer people living below the poverty line than we had in the later 1960s after the great war on poverty got under way. And there has been from that moment on a steady increase in the level of poverty . . ."

What are the established facts?: The percentage of the population in poverty in 1959 was 22%, but the combination of steady growth in the 1960s coupled with the War on Poverty cut this in half by 1969, to 11% of the population.

The poverty rate then rose modestly during the slow growth of the 1970's, reaching 12% in 1980. From 1980 to 1983 it rose by over ¼, reaching 15.3% in 1983. Under the impact of recovery, it declined to 14.4% in 1984. This translates into 33.7 million people living below the poverty line ($10,609 in annual cash income for a family of four). Leaving aside the Reagan years, this is the highest rate since 1966.

One should note in passing that the official poverty rates, which I have been quoting, do not include non-cash benefits such as Medicaid, Medicare, food stamps, subsidized housing, and school lunches. The Census Bureau estimates that if all these benefits were included, the poverty rate would be 9.7% in 1984 if the non-cash benefits are counted at market value or 12.2% if they are counted at less than market value because of the lack of freedom of choice.

Turning to the distribution of income, we find that the shares of total money income received by families at different income levels remained remarkably stable throughout the post-war period. For example, the 20% of families at the bottom of the income scale received about 4½% of total money income in 1947 and about 5% in 1980, while the top 20% received about 42% in both years. (The reduction in poverty was made possible by economic growth, which lifted all the boats, and by government transfers.)

Since 1980, for the first time in the postwar period, the distribution of income has worsened. In 1984, the poorest 40% of all families got 15.7% of all income, the lowest share on record, while the share of the top fifth rose to nearly 43%, the highest share since 1948.

The severe recession and unemployment of the 1980's clearly had something to do with these numbers. But as the objective studies of the Congressional Budget Office, the Urban Institute, and other groups have shown, the combination of the Reagan budget cuts and tax cuts has cut the incomes of the poor and increased the incomes of the wealthy.

One hopes that Mr. Reagan will recognize these facts about poverty and income distribution. At stake is his low opinion, indeed, his ridicule of anti-poverty efforts by the government, and his evident willingness to train most of the fire power of his deficit-cutting efforts on social programs that particularly benefit lower income groups. This has been amply demonstrated by his recommended budget cuts so far and would be carried much farther under the Gramm-Rudman bill that he has enthusiastically endorsed.

At the same time, one should acknowledge that the Reagan tax reform proposals include a doubling of the personal exemption and increases in the standard deduction that would take almost all of the families now in poverty off of the income tax rolls. Whatever else is done or not done in the course of tax reform, one would surely hope that this move would survive. One should note in this connection that if the income tax exemption were converted from income into a credit against tax, the lowest income groups could be fully protected with a much smaller loss in revenue. The political problem is that in converting the exemption into a tax credit, even if the value were doubled for the lowest income brackets, upper middle and higher income groups would actually experience a reduction in the tax value of their exemption.

But beyond the adjustment of the income tax, if I perceive the thrust of the President's approach correctly, his answers to the damning numbers I've just reviewed would be, "Give us time. Our policies will boost savings and investment, thereby increase the supply capacity, productivity, and growth rate of the U.S. economy and generate jobs. All this will lift the poor out of poverty."

Clearly, in spite of last year's improvement, we have lost ground on poverty and income distribution in the 1980's. What about jobs? Unemployment, after rising to record post-war levels in 1982, dropped sharply in 1983–84. But it has been stuck at about 7¼% for a full year (sharply above the 5.8% rate in 1979, before the recession started). The modest rate of recovery in the past year has not only failed to reduce the official unemployment rate, but has led to an increase in the category of "discouraged workers" (now numbering 1,231,000) and made only a small dent in the number of part-time workers who would like full-time jobs (now numbering 5,551,000).

In response to these discouraging numbers, Reagan Administration supporters point out that 9 million new jobs have been created since 1981 and that the U.S. experience is in bright contrast with the experience in Western Europe, where unemployment averages near 11% of the labor force. But to put this 9 million gain in perspective, one should note that the Administration argued in 1981 that its programs would create 12 million new jobs by 1986, 3 million more than if nothing was done. In other words, employment growth is achieving only the base line level that the Administration projected would exist in the absence of its programs. In short, we should not let the "9 million new jobs" argument blind us to the huge residue of unemployment we still suffer from nor to the fact that we are falling grievously short of the targets the Administration set for itself in 1981.

SAVINGS, INVESTMENT, AND GROWTH

That leads us into the even thornier thickets of the Reagan savings and investment policies. For presumably, if the tax and other policies of the 1980's were generating a strong surge of investment in plant and equipment, research and development, and technological advance, the payoff in more and better jobs and higher living standards would not be too far off.

Lamentably, the evidence gives no aid and comfort to this hopeful view. Yes, we had a big spurt of business-fixed investment in 1983 and 1984. But now, not only has that fizzled in 1985, but analysis shows that our savings and investment record of the 1980's has been the poorest in some 50 years. The tax stimulants to saving and investment have been simply overwhelmed by the ravenous appetite of the U.S. Treasury for over half of net domestic savings needed to finance its deficits, its dissaving.

(In the ensuing discussion of savings and investment, I base my comments on the excellent statement made by Barry Bosworth of the Brookings Institution before the Congressional Joint Economic Committee on September 17, 1985.)

It is true that the monstrous 1981 tax cut gave a powerful demand-side thrust to the economy that lifted us out of the 1980–82 recession. But as a stimulus to supply, it has thus far been a failure. Largely through the mountainous federal deficit, the Reagan program produced a pattern of national saving and investment that has undercut, reduced rather than increased, the long-term growth rate of the U.S. economy. Instead of an investment boom, we have been on a consumer binge financed by the liquidation of our assets abroad, by a skyrocketing import surplus, and by the lowest rate of national savings and investment since the 1930's.

If this sounds shocking and implausible, one needs only to look at the facts to substantiate the foregoing conclusion:

The tax cut did not budge the net long-run private savings rate of about 8%–9% of GNP. That is individual plus business saving minus replacement investment.

The gargantuan government deficit, or public dissaving, offset half of that. That is, half of all private saving had to be used to finance the budget deficit, with the result that the national saving rate fell from 8% to just over 4% last year.

To be sure, net investment stayed at about 7% of GNP, but that was made possible only by sucking in huge amounts of foreign saving.

Net investment by Americans is at its lowest ebb since the 1930's.

With respect to the inflows of capital from abroad, none of us can be certain that those flows will continue at a clip of $100 to $130 billion a year. If that stream were suddenly to dwindle, it would boost U.S. interest rates and severely impact capital formation and housing. But letting it go undiminished means that our external debt would reach $800 billion by 1990. At an average 10% rate of interest, that means an $80 billion annual bill for interest and dividend payments to foreigners, a bill that could only be paid by shipping out goods and services at the expense of the American standard of living.

But, critics may ask, what about that 1983–84 surge in investment spending? Doesn't that show that the tax cut worked and the investment picture is healthier than I have just implied? Taking a closer look at that boom, one finds that 93% of the increase in equipment spending since 1979 is accounted for by office equipment (mainly computers) and business purchases of autos (including small trucks). It is interesting to note that neither of these categories enjoyed a net cut in tax rates under the 1981 and subsequent tax acts.

The related point is that investment in American *industrial* capital has been steadily declining as a share of GNP. The benign impact of tax incentives has been swamped by the malignant impact of sky-high real interest rates, which in turn trace back in large part to the huge federal deficit.

Before turning to the deficit, perhaps we should ask: Won't tax reform restore the incentive for capital formation? Part of the answer is obvious: We don't know, since we at this point don't know either the ultimate fate or the contours of tax reform. But beyond this, I think economists should admit that the tax system is so complex and has such a multitude of special provisions for different types of saving and investment, that for most changes, economists can no longer tell you for sure whether a particular tax provision will in fact promote or discourage capital formation. What an economist can tell you is that cutting the federal deficit will increase national saving and private investment. Even here, one has to add, "provided that the cut in the deficit does not result in slowing down the economy as a whole through a reduction in demand."

THE DEFICIT AND GRAMM-RUDMAN

From the foregoing analysis, one can see that the massive deficits created by the largest tax cut in history coupled with the biggest peacetime defense buildup in history are defeating the very essence of Reaganomics by curbing the savings flow and thwarting the President's investment and growth objectives. Both by undercutting the rate of capital formation and by building up a huge foreign debt, these policies are also leaving a lean and bitter legacy for future generations that will have to do with a smaller capital base and a large liability for overseas debt service. Rudy Penner, the highly respected head of the Congressional Budget Office, calls it "fiscal child abuse."

In this light, it seems strange that Mr. Reagan is so adamant in barring tax increases as part of the deficit-reducing package. Perhaps one has to go beyond crass anti-tax politics and economic analysis to psychoanalysis to understand his position. Deep down, the President must be clinging to the conviction—contrary to virtually all the evidence—that holding firm on the tax front helps squeeze down government spending, especially on social programs, in response to the excruciating pressures of the deficits. Senator Durenberger of Minnesota last month said that he's about to subscribe to the theory that "there is some deliberate intention to use deficits . . . to get us to denationalize the financing of public services."

Ironically, it turns out that the huge Reagan tax cut, coupled with the big military buildup, is itself the greatest single source of non-defense spending increases through its impact on the public debt and interest rates. Net interest on the public debt has zoomed from $43 billion in 1980 to a projected $138 billion in 1986 and, at the present rate of increase, would reach over $200 billion by 1991.

If Senator Durenberger is on the right track in his assessment, it may explain why President Reagan has so enthusiastically embraced the Gramm-Rudman proposal for ending the deficit by a series of lock-step budget cuts. Since I testified on this proposal before the Joint Economic Committee last Friday and dealt with it in a commentary last evening on the Nightly Business Report on PBS, I would like, if I may, to offer these statements for the record. I will add only a few comments here.

The Gramm-Rudman formula is basically flawed in making no distinction between constructive deficits that can help the economy climb out of recession or overcome slow growth from destructive deficits that boost interest rates and undermine savings, investment, and growth. It fails to recognize the difference between the cyclical and structural components of deficits. Its weak-kneed provision for temporary suspension of its formula if a drop in GNP is forecast provides very little relief on this score.

Indeed, the Gramm-Rudman plan would send us on a mindless course (and also what even Senator Rudman has admitted is a gutless course) toward budget balance, no matter what economic, social, and military damage it might leave in its wake.

I yield to no one in my concern for bringing our monstrous budget deficit to bay. But unless the rigid and Draconian formula of Gramm-Rudman can somehow be transformed into a flexible but still Spartan plan to bring the deficit under control, I urge Congress not to fasten this ill-fitting straightjacket on itself.

ACCENTUATING THE POSITIVE

Let me now turn to a few more hopeful and even positive features of the macroeconomic policy scene in Washington.

It is not too late to reverse course and exercise damage control with respect to the federal deficit. Its impact are corrosive rather than explosive. It is not too late to shift or even reverse gears on curbing the deficit in a sensible way, coupling spending cuts with revenue increases and perhaps even removing the "off-limits" sign from social security. After all, a liberated David Stockman and an unrepentant

Martin Feldstein, both ardent supporters of Mr. Reagan's, are urging him to open the doors to a tax increase. Indeed, Mr. Stockman said that what America needs is a good $100 billion tax increase and "that the spending-cut episode is over."

And the new Director of OMB, James C. Miller III, sounded admirably flexible in his confirmation hearing when he said that "nothing is off-base, nothing is sacrosanct," went on to say that "some restraint in entitlement programs might well be looked at by the President and Congress," and did not even rule out tax increases as part of a budget package. Hope springs eternal.

Beyond this, we should give credit where credit is due on some of the more recent policy initiatives of the Reagan Administration that are both courageous and right-headed. Let me identify and applaud these moves on several fronts and, as you might expect, let me also suggest some additional moves that would help achieve and consolidate the gain promised by these new approaches.

First, the Reagan administration under the leadership of the Baker Treasury, has at long last recognized that (1) in large part, our trade deficit and protectionist pressures trace to a sharply overvalued dollar and (2) that this country does not have to stand by like a helpless giant, granting what amounts to a subsidy to imports and imposing a penalty on exports. But the job is not yet done. The initial success of the Big Five intervention efforts should now be bulwarked by narrowing the wide gap between our unduly loose fiscal policy and huge deficits and the unduly tight fiscal policies of our trading partners.

Second, the combination of the Big Five initiative and selective White House concessions on trade has apparently blunted the most dangerous protectionist movement since the 1930's. Protectionist legislation will still emerge from Congress, yet President Reagan's moves have apparently gained enough backers in Congress to sustain his promised vetoes. But the job is not yet done. Now, to keep the protectionist forces at bay and make U.S. producers steadily more competitive, Washington policy makers need to join hands in raising revenues and cutting spending to shrink the deficit, boost savings, and lower interest rates.

Third, with the evident blessing of the President, the Federal Reserve has commendably been clearing the path to renewed expansion by running a monetary policy that facilitated a sizable drop in interest rates this year. But its job is not yet done. To keep expansion going, to bolster fragile financial markets here and abroad, and to facilitate the Big Five moves to realign the dollar, the Federal Reserve should maintain an easier money policy. Continued economic slack, low inflation, and the declining velocity of money provide a low-risk setting for such a policy.

Fourth, within the past year, bright hopes were kindled for tax reform to reduce the complexity and increase the fairness of the income tax and, above all, to enthrone market advantage rather than tax advantage as a guide to the flow of resources in the U.S. economy. Base-broadening and rate reduction were the watchwords. The promise was a bright one. But hopes for a tough and meaningful reform seem to be ebbing. So the job is far from done. Unless the reform process is revitalized, the mountain may labor and bring forth only a mouse.

Finally, even on the budget deficit, some progress has been made. Jousting with an adamant Congress that controls the Pentagon purse strings, the President has broken his lance. The pell-mell defense buildup is being brought within more reasonable bounds. And Congressional appropriations committees are hard at work trying to make a meaningful dent in the non-defense budget for fiscal 1986 and beyond. But to say that the job is not yet done is to put it very mildly.

Chairman LAFALCE. Thank you very much, Professor Heller.

We will start first with Mr. McCandless.

Mr. McCANDLESS. Thank you, Mr. Chairman.

Dr. Heller, I appreciate very much your thoughts, and I would like to begin by saying that our President puts his trousers on one leg at a time like the rest of us, and is a human being, for whatever purpose that might have as a beginning comment.

One of the things that took place prior to my coming to Congress—and I do not have all the details readily at hand today—was what was referred to in October 1982 as TEFRA, in which the agreement was supposed to be that there were some terms of selective action increases that would be followed by tax cuts, and that the informal agreement was that for every dollar of tax increase there would be $2 in spending cuts, when the Congress only produced about 30 cents on the dollar.

Mr. **Heller**. The facts just cited are wrong. I am sorry to have to say this. I have looked into this carefully. I have written about it. And I will get you the Wall Street Journal piece in which I dealt with this.

[The Wall Street Journal article referred to follows:]

WALL STREET JOURNAL
December 19, 1983

FELDSTEIN'S RIGHT: DON'T BLAME CONGRESS

by

Walter W. Heller
University of Minnesota

Although the "Feldstein flap" -- the furor over the painfully candid public statements by President Reagan's economic adviser -- is now subsiding, one should not lose sight of five penetrating points about deficits that Martin Feldstein nailed down with both logic and numbers. And these, in turn, tell a lot about who is the major sinner in the deficit deadlock, the White House or Congress.

1. We cannot "grow our way out of those deficits." The "structural deficit" (the deficit that persists even at high employment) "is likely to grow just as fast as the cyclical deficit shrinks," says Mr. Feldstein. Under present laws, his numbers show a trillion dollars worth of deficits in the next five years. These numbers have been given added credence by the recent testimony of Rudy Penner, the head of the Congressional Budget Office. He projects a deficit rising to $280 billion by 1989 even when prosperity has eliminated the cyclical deficit. Under either scenario, by 1989 we would be footing an added bill of some $100 billion a year for interest on the new debt.

2. It is very risky to wait until 1985 to take the cure on these deficits. Mr. Feldstein shows that while federal deficits absorbed only about one-eighth of U.S. net savings from 1950 to 1980, they are now absorbing over one-half and are heading toward two-thirds or more. Those numbers spell higher interest rates, higher inflation, a lopsided recovery, slower growth and tougher sledding for the rest of the world. Mr. Feldstein's message: We must act now.

3. Budget cuts alone can't do the job. Tax increases have to be part of the cure. Says Mr. Feldstein: "I am convinced that the advantages of reducing the budget deficit outweigh the disadvantages of the proposed increase in tax rates." He urges action on the standby taxes President Reagan sought last winter: a near-$50 billion hike in income and oil taxes, to go into effect in 1985 if big deficits persist.

4. We can reject the claim "that any rise in tax revenue would simply lead to more domestic government spending, . . ." As Mr. Feldstein states, "There is in fact no basis in either experience or logic for believing that additional tax revenue at the present time would serve only to finance increased spending." His numbers are persuasive:

. Between 1960 and 1970, while general tax revenue (excluding earmarked social-insurance levies) was falling as a share of GNP, domestic spending financed by general revenues rose from 5.8% to 6.9% of GNP.

. Again, from 1970 to 1980, general tax revenue dropped from 16% to 14.8% of GNP while domestic spending financed by that revenue rose by over one-third. This "provides even stronger confirmation of the fact that spending does not automatically respond to changes in tax revenue."

5. Much of the ballooning deficits since 1980 can be traced directly to Reagan initiatives. The Feldstein numbers show that record tax cuts, defense boosts and interest payments swamp the president's cutbacks in the non-defense budget.

Mr. Feldstein now makes the point that the structural, or cyclically corrected, deficit "inherited" from Jimmy Carter was 2.2% of GNP by 1980. But that ignores three points: First, that especially under Mr. Carter's combination of a slower defense buildup and much more modest tax cuts, the structural deficit would be declining: second, that before Mr. Reagan's program got into full swing, the structural deficit did decline, to just over 1% (which makes one wonder what was "inherited"); third, that under Mr. Reagan's regime, it is rising to a projected 4.2% in 1988.

Underneath Mr. Feldstein's statistical prodding of the White House lies an implication he may not have intended: The real villian of the deficit piece is not Congress, but the White House.

While Mr. Reagan has been stonewalling the tax issue, he has been heaping scorn on the spendthrift Congress. That's a popular indoor sport these days, but it is both unwarranted and unfair. The record simply doesn't bear Mr. Reagan out.

First, it was Congress, led by Senators Robert Dole and Pete Domenici, that last year shamed President Reagan into accepting a tax increase that reversed some of the worst excesses of the 1981 tax cut. Not many people realize that our staggering out-year deficits would be $50 billion a year bigger if Dole & Co. had not initiated and won last year's Battle of Deficit Gap.

Second, mindful of the dangers of the remaining $200 billion-a-year deficits, Senators Dole and Domenici recently came back for more. They called for another big slash in the deficit, half from higher taxes and half from lower spending. But Mr. Reagan, unlike last year when he reluctantly climbed aboard the Dole Express, simply derailed it this year with a vow that he will "veto those tax increases, no matter how they arrive."

Third, whether one agrees with the big budget cuts to date or not, it remains true that Congress has given Mr. Reagan most of what he asked for. Again, we are indebted to Mr. Feldstein for giving us chapter and verse:

. All non-defense spending, apart from Social Security and Medicare, hovered around 9% of GNP during the Carter years. But Congress, driven by Mr. Reagan, has already pared it down to 7½%, and it is still falling.

. As Mr. Feldstein has also noted, the rise in Social Security and Medicare benefits as a percentage of GNP has been arrested and may now start falling.

. Thus, though ballooning defense spending and interest costs have boosted total budget spending from 23% to nearly 25% of GNP under President Reagan, Congress has gone along with the president on cuts that are shrinking all other federal spending as a share of the country's GNP.

Yes, say some, but didn't Congress double-cross Mr. Reagan on its promise to cut the budget $3 for every $1 of last year's tax boost? There are just two things wrong with this charge:

. The 3-for-1 pledge is a figment of someone's imagination. No one in Congress made such a promise.

Even so, with the help of Congress, the scheduled cutbacks for 1983-85 came to about 2.9 times the tax cut, surprisingly close to the mythical 3-for-1 promise. (One has to add that owing to skyrocketing farm costs, stubborn interest costs and White House failure to make scheduled "management savings," the scheduled cutbacks did not materialize.)

. And on the 1984 budget, Congress has met Mr. Reagan at least halfway. Against his requested spending of $505 billion outside of entitlements and interest, Congress enacted $506 billion. And it has already approved half of Mr. Reagan's requested deficit reduction of $30 billion in entitlements, with more to come.

Third, in defense of Congress, it should be noted that its budget resolution last June came a long way toward Mr. Reagan's request for a sizable standby tax. The resolution called for a $73 billion tax increase over three years, with most of it virtually in the form of the near-$50 billion Reagan standby tax for fiscal 1986. But Mr. Reagan torpedoed it. Had he accepted this overture as a basis for compromise, we might be well on the way toward shrinking the out-year deficits.

In the tax talk now leaking out of the White House, it is not at all clear whether Mr. Reagan will stick to the Reagan standby tax program. He has been something less than steadfast on this front. Now there is talk of inserting a "revenue plug" in President Reagan's new budget as an alternative to the standby tax. Again, it is unclear whether "plug" means (a) that he will simply plug for a big unspecified tax hike that will let him reduce projected deficits in a politically costless way or (b) that the phantom tax will plug a hole in the deficit dike or (c) that it will be a tired old nag pulling his budget wagon down deficit road or (d) all of the above.

Fourth, one should bear in mind that Mr. Reagan's own budget-cutting proposals would not put a very big dent in the budget deficits. At the same time that

Messrs. Reagan and Regan identified Congress as the root of all evil, the president proposed only $35 billion a year in budget cuts last January, a program that would handle roughly one-sixth of the structural deficit problem.

All in all, in the battle of the budget, Congress deserves a pat on the back not -- in Mr. Reagan's idiom -- a kick in the keister. Yet Mr. Reagan goes right on accusing Congress of a mindless tax-tax, spend-spend philosophy. He seems to think it is sounder politics and better economics to borrow-borrow, spend-spend.

Although there are some signs that Messrs. Reagan and Regan might listen to Sen. Dole's pleas for a 1-for-1 tax hike and budget cut, Washington wisdom has it that election-year politics foreclose any real possibility of action on the deficit in 1984. And it is surely true that unless the president has a change of heart, Congress -- no matter how deep and genuine its anxiety over the deficit -- cannot muster the will and the votes to put a big deficit-cutting bill on the president's desk.

It may well be that the president misjudges the mood of the country. People are much more willing to accept the bitter medicine of tax boosts and budget cuts to overcome the deficit disease than Mr. Reagan imagines. He underestimates the tonic effect of presidential leadership and responsibility in overcoming the political pain inflicted by the budget cuts and tax increases.

We economists, led by Mr. Feldstein, have emphasized the grievous economic costs of failure to face up to the deficits. But that may not be the worst of it. The sight of a do-nothing-painful White House and Congress, suffering fiscal paralysis for a year or more before an election, can only undermine confidence in government. That cost may dwarf the economic costs of our inaction on the mega-deficits.

Mr. Heller. First of all, who made that promise? I was absolutely unable to find any evidence that anyone had promised the three-for-one.

Second, when I checked out what had been done, and what was then, and the signals that were changed by the White House, Congress came very close—that 30-cent number is simply, I am sorry to say, completely wrong—Congress came very close, with the amendments made by the White House, to its own proposals; its own proposals came very close to conforming to this three-to-one.

Mr. McCandless. I am not in a position to say——

Mr. Heller. That is one on which I can speak with some assurances in having looked at it myself.

Mr. McCandless. I have a lot of trouble with the method by which we arrive here at our determinations, having come from two other levels of Government where it is required that you have a balanced budget. So I am quite a strong proponent of such a procedure and how we can get there as quickly as possible without creating chaos to the degree I find it necessary to have a constitutional amendment forcing Congress, since it has not demonstrated to this point over the years, irrespective of the President or who happens to be in Congress.

From your point of view, is it a balanced budget in the future as far as a policy, or would you even propose such a consideration?

Mr. Heller. Let me say, first of all, I have signed on with Governor Snelling as an adviser—that doesn't mean that I signed on to every policy nuance—to Proposition 1, which aims at a balanced budget at full employment, because, yes, I believe that when this economy is operating at full tilt, unless there is some extenuating circumstance, the Federal Government ought to be running a balanced budget.

Contrary to the impression that may have been created by some things I have said at various times over the past 20, 30 years, I have at times of full employment recommended that there be a balanced budget, and strongly urged President Johnson in late 1965 and throughout 1966 to turn the new economics the other way. If there is a tax cut in the recession, for goodness sakes, there should be a tax increase in the face of inflationary high employment—my record is quite clear.

I am one of those people that is in the very strange position of being a liberal decentralist. That is under the Wisconsin idea—and I grew up under the influence of the La Follette Republicans—there is a strong belief in strong State and local government. I have long been a firm advocate of bolstering our State and local governments.

I did my Ph.D thesis on State income taxes, so I have a long history of favoring strong State and local government, and that is a somewhat unusual position.

I am also credited with having been the author of what is now being repealed, apparently; namely, the revenue sharing, which was part and parcel of that philosophy.

Well, having tried to present my credentials in an immodest way, let me go on and say that the requirement for a balanced budget at the State and local level is an entirely different proposition than the requirement for a balanced budget at the Federal level. The State and local governments have to live like corporations, like families, et cetera, on the balanced budget principle.

That does not include capital expenditures. Those are financed by borrowing.

In the Federal budget—and this is the way it should be done; there should not be a separate capital budget because that would enable us to escape the discipline of the basic balanced budget principle—the Federal Government has to finance all of its capital, military expenditures, and so forth, in principle out of current revenues. We are not allowed to set aside the capital expenditures and borrow for those as the State and local governments are concerned.

Mr. **McCandless**. If I may put a caveat into this, in the State and local budgets there has to be a repayment procedure of these?

Mr. **Heller**. Absolutely.

Mr. **McCandless**. In terms of servicing the debt. And we don't seem to have that kind of discipline. We continue to borrow.

Mr. **Heller**. There is a total difference in the nature of the beast. The Federal Government has responsibility for serving as an economic balance wheel within the economy. If we had to enforce budget balance in the middle of a recession, that is where I suggested it is like a dog chasing its own tail: If you try to increase taxes and cut expenditures in the face of a recession, you will push the economy further and further down.

Second, the Federal Government has the Federal Reserve and monetary powers. So I think it is just dead wrong to force a rigid balanced budget rule year-in/year-out, even though I am in favor of aiming at a balanced budget of full employment.

Mr. **McCandless**. Without sounding abusive, I am reminded of the 1978 period in California politics where we had the conversion of Proposition 13, and the comments that you have made are reminiscent of some of the comments that were made at that time about the State would be in total chaos if such a restriction were placed upon local governments in terms of what they could charge property owners, property taxes and so forth.

The people seem to have had the wisdom that the politicians didn't, and voted Proposition 13 in. Chaos did not take place. There was not revolution in the streets, and so on and so forth.

The whole economy of California, at all levels of government, they are better off because people had to sit down and figure out ways to do things without having that crutch of being able to raise property taxes, without sincere justification.

Mr. **Heller**. I am interested in your comments. I have a family—a son, also an economist, a mathematical theorist, and I don't always know what he is talking about—and they live in Leucadia, and the level of services in Leucadia leaves an awful lot to be desired. They pay very low property taxes, and they are getting a very low level of services.

I have been in California and I haven't seen blood running in the streets. Now, while it may be a good thing to hit the mule over the head with a two-by-four—and I have no doubt that it caused some desirable rethinking of Government programs, and I don't deny that for a moment—but it imposes an arbitrary limit and has undercut the level of services in a lot—I am taking a sample of one—in a lot of California communities.

Mr. McCandless. I don't know what your pleasure is.

Chairman LaFalce. Mr. Carper.

Mr. Carper. Your comment reminds me of an old quotation attributed to the wife of Dr. Einstein, who said, "I understand his words, but not his sentences."

For the lower percentage of income earners, the top percent, between the late 1940's and 1980, their comparative shares have not really changed that much—the lower one-fifth of wage earners had 5 percent of the income, and the top 20 percent had 42 percent of the income.

Is that pretax or aftertax income? If we differentiate, does it make a difference?

Mr. Heller. That is pretax, total money income. And that is a very important point, you know. When you are trying to get a measure of what income is being thrown off by the American private economy, that is the kind of a measure you use. And what those numbers say is fundamentally—over that long period of 40 years now, that distribution hasn't changed very much.

We change it by taxes and transfer payments, but what the American economy does by itself is pretty much the same distribution of income, and it is really very hard to explain. When you think of all the things that have happened in the past 40 years, the idea that there should have been offsetting circumstances is surprising.

Bob Lampman, an expert in poverty and income distribution from the University of Wisconsin, says he, too, is puzzled—how has it happened that it should have remained so stable? But those are the facts.

Mr. Carper. Aftertax income, State and local, Federal taxes, were those relative figures, 5 and 42 percent? Would they change?

Mr. Heller. I think they would, although it is hard to find numbers—at least I haven't found them—that show the posttax distribution. That probably is a deficiency on my part, but I haven't seen them. That probably would show some improvement of the distribution of income taking taxes into account, but payroll taxes are making the tax system less and less progressive.

Mr. Carper. Earlier this year, the Reagan administration announced the numbers of people living in poverty actually dropped.

Mr. Heller. From 1983 to 1984, correct.

Mr. Carper. Is that a real improvement? Could you characterize, in your own words, what the significance of that is?

Mr. Heller. I tried to do a little of that in my statement. What I pointed out was that in 1980, the official Census Bureau poverty rate was 12 percent, and that rose to a high of 15.3 percent in 1983—a combination of recession, budget and tax cut policies—and it receded to 14.4 percent in 1984. But, leaving aside the Reagan years, that is still the highest rate since 1966. So we are still—you know, that is 33.7 million people still living in poverty, with a poverty line defined as $10,609 annual cash income for a family of four.

Mr. Carper. You and Rudy Penner gave Congress the credit——

Mr. Heller. Dave Broder is also with us.

Mr. Carper. Pretty good company.

My recollection is, a CBO estimate of 1980 deficits, the deficit will still approach $150 billion in 1988.

Mr. **Heller**. Right.

Even though I give a lot of credit to Congress, it is more like $160 billion, yes.

Mr. **Carper**. We have gone to conference. We have received from the Senate their Gramm-Rudman amendment and go to conference, and they may even be meeting today to determine what kind of compromise we might work out. The likelihood is that we will work out some compromise.

What advice would you have for us as to how if we are going to do something, come up with a compromise, what form should it take?

Mr. **Heller**. I tried to do a little of that with the Joint Economic Committee last Friday. I gave you my last copy. I have a summary there.

May I read from that, because I tried to be constructive toward the end of my testimony?

Here are the things I suggested, and you might want to follow up on this. I said the obvious answer is to change the Gramm-Rudman prescription. I said if the legislative juggernaut—and you sometimes do have those in Congress—is relentlessly rolling us to passage, what would you do to make the cure better than the disease rather than worse than the disease?

The obvious answer is to change the Gramm-Rudman prescription so as to maintain the central principle of the aggressive reduction of the deficit.

Remove the side effects. How? First, provide sensible safeguards on the economic front by changing the unworkable antirecession provisions of the Senate bill, relating them not to forecasts of two-quarters of GNP decline, because that is the requirement now, but rather to some reasonable growth rate of GNP, and preferably to the rate of unemployment.

As I thought about that, even that is probably not enough. You probably ought to be a little sophisticated about it and relate it to the GNP gap, the gap between where you are and where you could be, if you were at some reasonable level of high or full employment. And if that gap is large, then lay off; and if it is small, lay on.

Second, open the budget reduction process clearly and candidly to revenue increases, perhaps even providing for triggered tax increases under specified conditions. A stand-by surcharge on corporate and individual income taxes would be one very simple way to go.

Third, remove the absolute prohibition of any modification of Social Security indexing.

Mr. **Carper**. Most of the people behind you appear to be under age 62.

Mr. **Heller**. Remove the rigid cuts that now focus the firepower on the social programs. And, finally, correct the technical anomalies in the Senate bill relating to the definition of "controllables" and "uncontrollables" that would have such a distorting effect within the defense budget itself.

It is dangerous to have a formula that will leave the weapons systems unscathed and cut the readiness forces. If the weapons systems get a cut, you have to stop building them.

Mr. CARPER. Maybe we can stop building the ones that are not meeting the specifications of the tests that they are supposed to be meeting.

Mr. HELLER. Maybe you could cancel something else, like Sergeant York and DIVAD.

Chairman LAFALCE. The time of the gentleman has expired.

Dr. Heller's Congressman, Bruce Vento.

Mr. CARPER. Dr. Heller, I wonder if I might retain that copy for just a moment and have a copy made.

Chairman LAFALCE. We will give a copy to everybody.

Mr. HELLER. I asked to have that entered in the record.

Mr. CARPER. I thank the gentleman for yielding.

Mr. VENTO. I thank the gentleman.

I am delighted that Dr. Heller has been speaking out this past week on the issues. We ought to bring all the discussion to bear on these startling proposals that are being made to, I call it, Republican anarchy, with all deference to my colleagues on the other side of the aisle, with regard to the budget.

From a political standpoint, it looks like we all came in with a lot of baggage last year and came up with this consensus in August, and in September somebody says we are not going to do this, this is hard to live with. I agree, it is. But unless there are some fundamental changes in terms of policies—I mean, the description that you have given out to us—and I am happy that you have been discussing this and that you appear before our committee and before the JEC to discuss these—it is essential. The sort of safeguards you are talking about, that is what the Congress normally does when we go through this process.

The only thing we are being asked in this proposition is to do this 5 years in advance. We have a very difficult time. I would say the budget number differences that were pointed out, in terms of our stated intentions and goals with regard to budget savings, are the same discrepancy that would occur within the context of what the President had recommended in the budget savings in February's budget because we are using common economic bases.

Insofar as the economy is not performing along those lines, then we end up with those particular conclusions. So trying to do this 4 years in advance, all at once, within a time frame of a couple of weeks because of a debt ceiling, is difficult. Some would have had us do it in 3 days if they had had their way. Clearly, they did not, so this is receiving some attention now.

The first question is, isn't this really suggesting to us that we have to know what the economy is going to be for the next 4 years?

Mr. HELLER. Well, let me give you a slightly ambivalent, I hope not ambiguous, answer to that. You have to do some 5-year planning. But to lock yourself in for 5 years doesn't make any sense. I was asked about it—am I ever for a balanced budget? Yes, at full employment. But how do we know we are going to have full employment in 1991? And further, it is not always desirable to have a balanced budget even at full employment.

There are times when the willingness to invest—we call it, in our jargon, propensity to invest—in the American economy is too weak, and you may need a modest deficit, even at full employment. If you had a $50 billion deficit, full employment, by 1990, it would be 1 percent of GNP. I am not sure that would be a horrible sin.

Any lock step, straightjacket like Gramm-Rudman is going to result in capricious effects on the budget and on the economy.

Mr. **Vento**. We have to do long-term planning; all of us would agree with that. I have not addressed the context—and it is not our role to talk about constitutional power separation, executive and legislative branch, which is also a root concern many of us have just talking about economics—whether or not we have the precision in terms of economics to deal with that. We all strive for it. But the fact of the matter, looking at the projections that we are utilizing, I guess that is the best cut the administration could make in February.

As to where we are today, we got a $20 million gap between what we projected and what occurred, and we are trying to project 8 months in advance, not 4 years.

Mr. **Heller**. Right. And we can't even predict what is happening in the economy right now. After all, there is a lag in data. And sometimes you may be in a recession and you may not know it.

Mr. **Vento**. That is exactly right, just even in the current fiscal year.

There are other goals, other agendas that are within the context of such proposals; that is to say that the Government should not have a role in terms of being a countercyclical force in the economy.

I wonder if the Government could withdraw from having an impact on the economy. I suspect, in the context of the military spending, it would be nearly impossible. So the next best thing is to approach this on an intelligent basis rather than pretending as if the Adam Smith process were as he left his pen in terms of reality here today.

Mr. **Heller**. Those of us who lay it on the line in economic forecasting know these hazards all too well.

I don't know whether the staff distributed copies of the economic policy and outlook letter for release tomorrow that I did for the National City Bank of Minneapolis. I do this twice a year with George Perry of Brookings, and it happened to come at the same time. And I have some extra copies here.

Mr. **Vento**. I will certainly look at that.

I wanted to make a few more points.

Mr. **Heller**. I would just add that in that forecast I do not happen to see a recession either this year or next.

Mr. **Vento**. Well, I hope that that is correct. But, frankly, given the problem that you are trying to attack and predict, I think it is a very difficult matter, indeed.

What about the phenomenon—and these are the sorts of things that are occurring—I mean, the trade issue. The Joint Economic Committee recently had hearings on a Department of Labor report that indicated a decline in manufacturing. They took all the manufacturing indices. One hundred and nine out of 137 are still not back for their employment levels of 1980, about three-quarters of them. That is a definite shift away from manufacturing and service into other activities.

Employment increases did occur in those remaining industries, some 32 or 27, the remaining number.

What is the significance of that, Mr. Heller?

Mr. HELLER. Part of it is the overvalued dollar. The industries hurting the most are the ones dependent on exports. You know about our Minnesota farmers, and the exports of Honeywell, 3-M, and so forth, and a lot of smaller companies, H.B. Fuller and many others, are being very hard hit by the fact that the dollar is so expensive.

As I said, a lot of people have attributed about two-thirds of the trade deficit simply to the overvalued dollar. That is why I applaud the "High Five," the top five industrial economies of the world. I applaud their agreement to try to move the dollar down, both by announcement effects and by selling dollars. But you have got to back that up by cutting the U.S. budget deficit, which is holding interest rates so high and sucking in foreign money.

A lot of manufacturing industries have taken a beating, and the hope for the industrial investment surge that was part of the Reagan philosophy has not materialized, because how do you sustain a big investment surge if you don't have expanding markets? Sure, you do some things to improve productivity and invest in labor-saving devices.

Mr. VENTO. What has caused a surge in the economy is consumer spending, isn't it? It hasn't been an investment surge?

Mr. HELLER. Particularly on services.

Chairman LAFALCE. Congressman Lundine.

Mr. LUNDINE. You are like a cool wind on a hot summer day. I don't agree with all your conclusions, but it is great to hear from you. And your searing analysis is really fascinating. But I want to start off with statistics.

I wish I had the chart Treasury put out that purports to show that investment has been greater during this recovery than during any sustained postwar recovery. And I compare that with your statement on page 6. "Industrial" is underlined, and I am perplexed.

The anecdotal evidence to me seems to show a lot of disinvestment in this country, and Treasury statistics seem to indicate otherwise. Can both be true?

Mr. HELLER. That is part of the problem with economics, because time and again you can find data that seem to support two rather opposite or conflicting conclusions. No doubt that Treasury is right that there was a big surge of investment in 1983-84, but it was from an abysmally low level, is part of the problem.

Second, so much of it went into business equipment, you know, computers and so forth, and trucks. And, by the way, just to show you how slippery statistics are in this field, if you have a big surge in leasing of cars—suppose I lease a car instead of buying a car. Suppose the leasing company buys a whole fleet of cars to supplant what were previously cars bought by consumers. That then shows up as a shift from consumption to investment, because the leasing company is investing in those cars. And some of that is going on.

That is part of that so-called investment surge. So the very low level we were starting at, that is one point.

Second, the composition which was not all that great in terms of what we need in this economy, fundamental investment, industrial productivity and capacity.

And third, just some changes in the habits of—not that this is a major—the third one is not a major thing, but the illustration about cars, some changes of that kind.

But then what I was doing in this discussion—and since this is a special interest of yours—you may want to go over the testimony by Barry Bosworth before the JEC on this point—he has done the most outstanding work on the development of investment and savings in the American economy in recent years. He has a lot more back-up to the points I have been making here in his testimony, and I yield to him in these areas.

When you add up the net investment by Americans, when you subtract the investment that has been made by overseas investors in America, then you come up with the conclusion you can't escape—that this is the lowest level of investment by Americans since the 1930's. That is another distinction—that a lot of investment that we are doing is building up claims of overseas investors against our production of goods and services.

Mr. **Lundine**. Turning to trade, you indicate that you applaud the G-5 effort and you think it needs to be sustained by reducing budget deficits.

Is there anything further that you would recommend with regard to improving our trade balance?

Mr. **Heller**. Well, things that are done to provide open foreign markets, I applaud. I don't mean slapping on huge import quotas and tariffs, but to the extent that we can exert some pressure—and we always think of the Japanese, but the Europeans, too—to the extent we can exert some pressure on them to open up their markets, at least as far as we open ours—we are not totally open, either—I think that is very important. It has been a very tough go with our Japanese partners.

I remember so vividly, we went over in 1961 with the Japanese—United States-Japanese Trade and Economic Committee. Six Cabinet secretaries and I were members of that committee. We went over to Japan, and some of the rhetoric and some of the negotiations remind me of what is still going on in 1985.

We were, at that time, trying to get the Japanese to open up their markets to us.

Chairman **LaFalce**. 1965?

Mr. **Heller**. No; 1961. I am saying, still in 1985, we are trying to do some of the same things we were trying to do in 1961, nearly a quarter of a century ago.

It is a tough go to get the Japanese to do, in fact, as well as in word and law, what they ought to do in opening their markets to our goods.

I am against, as you can plainly see—I am just against outright protectionist measures that probably cost the U.S. economy more than they gain.

Mr. **Lundine**. What would be your opinion of a long-term effort to try to have more stable exchange rates? They seem to have defied fundamental economics. Would you favor looking at the possibility of closer coordination, both on macroeconomic policy and on international monetary policy, setting target zones, or something like that, that the countries would try to look at over a longer period of time?

Mr. HELLER. I lived under the regimen of fixed exchange rates and served as a presidential envoy a couple of times to talk to Prime Ministers of Britain, trying to persuade them not to cut their exchange rate—which, by the way, I have decided in retrospect was the wrong thing to do. I remember the mischief that was done under fixed exchange rates, so I certainly don't want to go back to those. But, a lot of mischief has also been done now under untrammeled free exchange rates, uncontrolled.

I was very much in favor of Nixon's decontrolling exchange rates and cutting the umbilical cord between the dollar and gold and so forth, but some curb, perhaps some target zones, something like that deserves attention.

Others have persuaded me we ought to take a very close look at that as a possibility, because the tremendous volatility of exchange rates is uneconomic. And I would be willing to try. I don't consider myself an expert in this field, but what has happened with totally free exchange rates has been in a considerable way disruptive. So I would like to see a system developed, if it is possible, that might put in target zones without putting us in a straitjacket.

Mr. LUNDINE. I am curious about your comment that you don't believe we ought to have a capital budget at the Federal level.

If what we are doing now is fiscal child abuse, why shouldn't we separate out those expenditures that are for operating purposes from those that are really investments, that it is not irrational, even at the Federal level, that our children should pay for things that they are going to use over their lifetime, but it is irrational to do as we are now—to basically spend all the money for our current needs and consumption and borrow it for the future?

Mr. HELLER. We do separate them in the budget document. We have the special analyses, and it shows what is spent for capital expenditures.

You have a very difficult problem. Our capital expenditures are not just bricks and mortar. I'm in the business of creating capital expenditures by teaching in the University of Minnesota. In other words, how do you distinguish between investments in human brain power, in investments in plant and equipment and research and development? So you have a purely definitional problem.

I don't mean to avoid your question by reference to the definitional problems. I do think it is important to segregate the capital expenditures—as we do—and to recognize that those are an important investment in the country's future. And I think those infrastructure investments and so forth have been badly neglected.

I am amazed at the supply siders putting all their emphasis on tax cuts and absolutely ignoring the fact that to build the base for private capital investments, you have to have public investment. And from that standpoint, I am very sympathetic to the capital budget idea.

The trouble with it is, if you segregate capital expenditures and say these could be financed by borrowing, because that is sort of the logical next step or inference, and the rest be financed by taxes, you are going to have the Federal Government borrowing money and running a big unbalanced budget at full employment when it should be running a fully balanced budget. It will be wrong-way fiscal policy.

I hate to admit that I wrote a long study on the capital budget and formulated my opinions in 1955, and I have not changed, which may show a certain inflexibility. But I really applaud the idea of recognizing capital investments, investing in infrastructure on one hand, but not letting that guide fiscal policy on the other.

Mr. **Lundine**. Thank you, Mr. Chairman.

Chairman **LaFalce**. Dr. Heller, a few brief questions. I am concerned about the distribution of income, and I was pleased at Mr. Carper's question comparing posttax distribution. I know you don't have that data with you now but I wonder if you have given any thought at all to the effect of the automatic increases that take place in the Social Security tax and its impact on the posttax distribution of income, even though we don't have the data before us right now.

It seems to me that we do have a call for an automatic increase in the Social Security payroll tax. And, because of its regressive nature, that has to aggravate the equitable distribution of income tremendously.

It concerns me that in calling for tax reform, we address exclusively the subject of the income tax when the fact of the matter is that more Americans are paying more of their Federal tax burden in the most regressive tax we know—the payroll tax.

Mr. **Heller**. I could not agree with you more that the payroll tax has been the single most forceful action toward reducing the progressivity of the American tax system, and increasing its regressivity, especially at the bottom.

That raises the whole question of whether it is an insurance payment and therefore, shouldn't be considered taxation.

Certainly, the system hasn't worked thus far as a strict insurance policy. If it were, my Social Security benefits would be lower than they are going to be. We have not operated it as an income-oriented, means-tested transfer program. If we were, I shouldn't get any Social Security benefits.

We have a somewhat anomalous situation, but if you ask, what is the most regressive force on American taxation, if you consider payroll tax a tax, and I do, there is no doubt that the Social Security payroll tax has hit the lower income groups hardest.

Imagine putting in a tax that has no exemptions, that taxes you from the first dollar of income, makes no difference by family size. I have to be a little careful here, because I made this same point before the Senate Budget Committee when Bob Dole was sitting on that committee, and quoted a Washington Post editorial, which said, "If you put the three most reactionary lawyers in a dark closet and asked them to come up with the worst tax you could think of, they would come up with the payroll tax."

Then I was so unwise to say, I am glad they didn't say economists, and Bob Dole said quick as a flash, "They were already in there."

I agree with what you are saying. It is a very vexing question.

Chairman LAFALCE. It is being written about. We have some economists writing about it, articles in the Wall Street Journal, public interest magazines, and I don't think Congress will ever address the issue.

Mr. HELLER. We had floated a proposal and President Carter signed on to it very late in the game. I think it is reflected in his last economic report that there be an offset to the payroll tax in the income tax, and that never got anywhere.

Chairman LAFALCE. That was defeated.

Mr. HELLER. Yes, and that would have taken a good bit of the regressive bite out of the payroll tax. It would have cost money, it would have been a good way rather than our 10-10-10, or eventually a 5-10-10 income tax cut.

Chairman LAFALCE. I don't see anybody speaking about the regressivity of the income tax in economic or social circles.

Mr. HELLER. Joseph Pechman at the Brookings Institution has a study showing what has happened to the distribution of tax burdens by income size over the years. It is in a recent book within the past year.

Chairman LAFALCE. Mr. McCandless.

Mr. MCCANDLESS. Thank you.

Dr. Heller, I had the opportunity of spending some time in Seoul with the World Bank-International Monetary Fund Conference, and the gratifying part about those kinds of things is you learn more in the informal setting than you do in the formal aspect of it.

I had some heavy discussions with Robert Anderson, former Secretary of the Treasury. It was a relaxed atmosphere and he is attempting to, on a worldwide basis, create an organization that will address the issues that we have, and other countries have of spending, the economy of and lack of productivity, and all those good things.

He expressed, as did some others, without the benefit of that dialog, a genuine concern that the world's economy and its future lies in the hands of 435 people of Congress who have the responsibility for appropriations, and that if we do not change our ways and address the issue, that it is not going to be very long, a time lag of 18 months to 2 years, that the world economy is going to begin to disintegrate, because the dollar is the basis upon which all of the world's currencies are pegged, or is pegged, and that what the dollar reflects in the way of fiscal responsibility on the part of those who are responsible for it being not indefinitely endure current trends and policies of a legislative basis.

That is a real brief description of the dialog that we had with some other members in a hotel room that I had the privilege of joining them, some Argentines and some others who find themselves in a far worse condition than we ever have, but who understand, because of their direct experience, what problems arise when you let your economy get out of hand; 100-percent-plus inflation these gentlemen were talking about, giving their experiences, how it is impossible to manage.

Do you have any comment on that?

Mr. HELLER. The Argentinians were a few months ago running 1,000 percent inflation a year.

Mr. McCANDLESS. I am reminded of some political statements, and I don't like to use those.

Mr. HELLER. Mr. Alphonsin and his program have been successful so far, and inflation is way down. I don't know if they can continue. Well, does the fate of our economy rest on the dollar in large part, and the answer is yes, indeed.

If we don't run a reasonable fiscal and monetary policy and keep sucking in $110 to $130 billion a year of foreign funds, even from these countries that so desperately need to invest capital in their own economies, and maintain very high-interest rates that make it difficult for foreign countries to expand their economies, we are doing a lot of mischief in the world.

Of course, none of these questions are black and white. I mean, our expansion and our strong dollar have provided a lot of stimulus, most of the stimulus that the European economies have had for exports, which is a good part of their basis for recovery.

They toss their hats in the air when they have 2 or 3 percent rates of recovery, which we regard more or less as a growth recession, so we have a tremendous responsibility in the world to run a responsible fiscal and responsible monetary policy here at home, and to try to coordinate policies, but they have got to do their part, too.

I do not look for Armageddon or something like that, but I think former Secretary Anderson's emphasis on the international responsibility we have is absolutely right. The other thing is, from our standpoint, our economy has been externalized, and any of the data you look at with respect to foreign trade as a percentage of our GNP 20 years ago and today, shows that we obviously have to pay a great deal more attention to the external aspect of our economy, and that is why I like the Group of Five initiative, because it tries to do something about it.

Mr. McCANDLESS. What I am trying to get at here is, it all comes back here to the House of Representatives and what we do or don't do, and it is kind of a house of cards, so to speak, so when we talk about trying to find answers to current solutions, it goes beyond that of the borders of the United States and our own standard of living, and so forth.

Mr. HELLER. Absolutely. When I look at the external dimension of economic policy back in 1961, when President Kennedy was very much concerned about the dollar and gold and so forth, that is nothing compared with these impacts today.

And so, it is true, if we don't get our budget deficit and interest rates down, we are doing damage to the rest of the world.

Mr. McCANDLESS. One more question on another subject, if I may, Mr. Chairman?

In going back over the history of certain parts of our tax program, those that directly relate to business, and in preparation for trying to do something tomorrow in front of a group, I find that we have had almost an annual change in various aspects of our business taxes to the degree that we talk about some long-range planning, 5-year planning, and it would appear that those who are responsible for investing, machinery, shop equipment modernization, increased production, are somewhat saddled with, what is the tax law going to be next year?

Has that had an impact upon investment?

Mr. **Heller**. I think so, and I speak here not just as a professor, I serve on the boards of six corporations and I know something of what happens inside the boardrooms and the decisionmaking mechanism. You are right, if the tax system is going this way and that, it does create some inhibitions to investment, and at other times a stimulus.

They say, well, if we are going to have our investment tax credits taken away next year, we better get our investment done now, and those tax considerations, I am not going to say they are uppermost, but right up there.

Chairman **LaFalce**. It is always good to threaten repeal?

Mr. **Heller**. That is right. That will stimulate the economy, but those are very important and that is why I arrive at a conclusion that certainly must fit with your philosophy, that we should try to lift the onus of the tax system and all the special provisions that distort the flow of resources by having a thoroughgoing removal of tax preferences.

The pure Regan tax proposal of a year ago, I am thinking of Treasury 1, startled us and pleased us at the same time.

Mr. **McCandless**. That was intended to be the two-by-four?

Mr. **Heller**. Yes, it proposed to restore market incentives rather than tax incentives which are distorting the flow of resources, and I guess Regan said, "When I find that Heller and Pechman are supporting my proposal, I wonder where have I gone wrong?"

The point is, he really had gone right. It would be good in the long run, it would cause a lot of handwringing and difficulties in the short run, as you adjust to the system, but it would have restored the judgment of the marketplace.

But I don't expect that to come out of Congress or the White House.

Mr. **McCandless**. I appreciate the opportunity of visiting with you, Professor Heller.

Mr. **Heller**. Thank you.

Chairman **LaFalce**. I have met with former Secretary Anderson many times, too. I would refer his conversations to 435 Members of the House and 100 Members of the Senate responsible for appropriations, and also for the raising of revenues.

I wanted to put that in balance as we attempt to balance our budgets.

Mr. **McCandless**. Duly noted.

Chairman **LaFalce**. Dr. Heller, thank you very, very much. It has been a great education and experience. Thank you.

The subcommittee is adjourned.

[Whereupon, at 11:50 a.m., the subcommittee was adjourned.]

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